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Refocusing Agricultural and Rural Development Policies in **Ukraine**

Action Plan for the Road Ahead



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Abbreviations

APK	agroindustrial complex
AMS	aggregate measurement of support
CAE	collective agricultural enterprise
CAP	Common Agricultural Policy (EU)
CEE	Central and Eastern Europe
CMU	Council of Ministers of Ukraine
CSLC	Center for State Land Cadastre
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FAT	fixed agricultural tax
FOB	freight on board
GAO	gross agricultural output
GDP	gross domestic product
GOST	Soviet food safety standards
IDF	International Dairy Federation
IER	Institute for Economic Research and Policy Consulting of Ukraine
LEADER	Links between Actions for the Development of the Rural Economy Program (EU)
LGE	local government entity
MAP	Ministry of Agricultural Policy of Ukraine
MDA	Ministry of Internal (Domestic) Affairs
MPS	market price support
NBU	National Bank of Ukraine
NGO	nongovernmental organization
OECD	Organization for Economic Cooperation and Development
PPP	purchasing power parity
PSE	producer support estimate
RER	real exchange rate
RLTCD	Rural Land Titling & Cadastre Development Project (World Bank)
SBU	Security Bureau (Services) of Ukraine
SCLR	State Committee on Land Resources

SMEs	small and medium enterprises
SPS	sanitary and phytosanitary
TACIS	Technical Assistance for Commonwealth of Independent States (EU)
TFP	total factor productivity
TSE	total support estimate
UAH	Ukrainian hrynia
UN	United Nations
UNDP	UN Development Program
USAID	U.S. Agency for International Development
VAT	value added tax
WHO	World Health Organization
WTO	World Trade Organization

Introduction

William H. Meyers

Our study challenges policymakers and stakeholders in Ukraine to design a road map to a dynamic and competitive agriculture and rural economy. We hope to challenge all participants in the policy dialogue to think carefully about how alternative actions will slow or accelerate progress toward realizing the great potential that exists in Ukraine's rural space. We urge policymakers to reject the failed policies of the past and act boldly in forging a new path for the road ahead.

The author of each chapter states the main goals that have been or should be adopted for that policy theme. Lessons learned in other countries are discussed, along with evolving best practices relating to policy choice and the policy process, according to academics and practitioners. Some key constraints and problem issues in Ukraine are also identified and evaluated. Each chapter concludes with action recommendations that highlight the main directions and processes for successful policy formation and sustained growth in agriculture and the rural economy over the next decade.

We adopted four recent publications as our principal background papers (see reference list) and consulted a number of policy stakeholders in Kiev, Lviv, and Odessa to hear differing views on a broad range of issues, constraints, and potential remedies.

From these consultations and our review of various reports and articles, we assert that the overriding goal of Ukrainian agricultural and rural policy is to transform the rural economy of Ukraine

- *from* high farm employment, low farm efficiency, few nonfarm jobs, and low rural incomes
- *to* lower farm employment, higher farm efficiency, many nonfarm jobs, and higher rural incomes

Attaining this overriding goal will harness Ukraine's rich human and natural resources to increase agricultural efficiency and competitiveness, develop a diversified and dynamic rural economy, enhance and sustain national economic growth, and reduce regional disparities. If rural development is not pursued simultaneously with

agricultural competitiveness, increased efficiency and reduced employment in agriculture will leave many workers with no alternative but to leave rural areas.

As emphasized in the policy concept paper (UNDP 2005), policies for agriculture and rural development are not one and the same. They are certainly related, but it is clear that agricultural policy does not address many of the problems in the rural economy and can even make them worse. Though agriculture is the core of the rural economy in many areas, it should not become a limitation. We thus focus two chapters on rural development and local government issues and others on fundamental agricultural policy issues—the land market, agricultural regulation, agricultural support, and agricultural taxation. These must be resolved to realize the full potential of Ukraine's food and agricultural industry.

Aside from the need to develop the full potential of Ukraine's agricultural and rural economy, the country's pending membership in the WTO and its longer-term goal of integration with the EU provide both opportunities and imperatives for concerted policy action. Too much time has passed since Ukraine began the transition to a market economy, and progress has been too slow. Previous studies identified many obstacles to progress, but a common theme has been an excessive reliance on government direction and lack of confidence in market mechanisms.

An example fresh in many minds is the aftermath of the poor harvest in 2003. Rather than letting market forces resolve imbalances created by the drop in production, the government undertook a series of short-term, ad hoc measures that did not have the desired effect and, in most cases, made matters worse. A more recent example of similarly unwise government intervention was the introduction of price and margin controls for meat in May 2005. Quick fixes and ad hoc measures sometimes tempt policymakers and stakeholders who influence policy, but too often these have unintended or unexpected consequences and negative impacts. What farmers and agribusinesses need is a stable and consistent long-term policy environment in which to make management and investment decisions. An erratic policy environment increases uncertainty and reduces efficiency in the whole sector.

Ukraine is not alone in facing the challenges of transition. Many countries in the region started down this road at the same time or even earlier. In all cases, the removal of the distorted production and delivery systems that existed under state planning in Central and Eastern Europe (CEE) and the Soviet Union resulted in declining production in agriculture and lower incomes in rural economies. But the countries that were the most effective in removing these distortions and developing functioning market mechanisms and stable policy regimes were those that recovered most rapidly.

In Ukraine, the gross agricultural output (GAO) per agricultural worker during the last few years is only about half the levels of Poland, Latvia, and Lithuania, which have the lowest GAO per worker among CEE countries that joined the EU in 2004 (figure 1.1). This performance is especially disappointing, given Ukraine's more favorable soil and climate conditions. A major reason why labor productivity is higher in Poland,

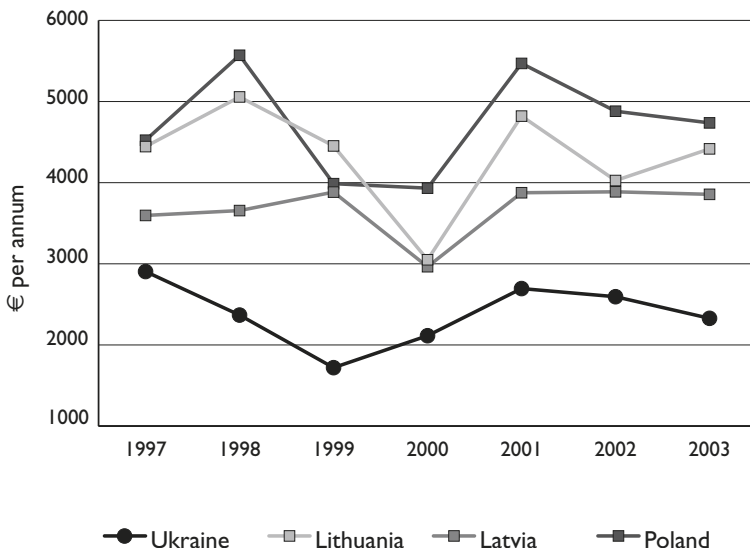
Latvia, and Lithuania is that the number of workers in agriculture has declined by 30 to 40 percent since 1996 (figure 1.2). In Ukraine, there has been a large shift of labor from large enterprises to personal farms over the same period, but only a slight decline—8 percent—in total employment in agriculture.

Ukraine did not have a more difficult starting point than other transition countries, but it has long delayed the kind of bold action that many of them took. As a result, efficiency gains that other countries experienced have also been delayed. The lesson for Ukraine—and other countries that delay reforms and restructuring—is that pain delayed is pain prolonged.

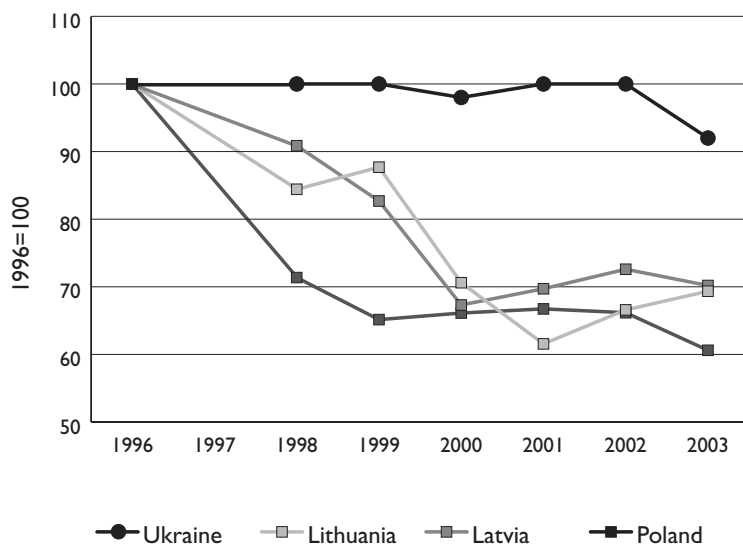
Though lessons learned from neighboring and other countries can help inform the policy process and decisionmaking in Ukraine, there is no perfect analogy from which to draw a magic policy formula. However, we present ideas on policy options and policy processes that we believe will lead to improved strategies and choices. We also discuss options and consequences to evaluate the wider and longer-term impacts of policy choices.

In Ukraine, short-term, ad hoc measures and interventions have often created uncertainty and been counterproductive. Too often, analysis was lacking or did not recognize the complexities and interdependencies that characterize market relationships. The government cannot manage the market, and past failures demonstrate this. Instead

Figure 1.1: GAO per agricultural worker



Sources: Ukraine data from National Bank of Ukraine; data on other countries from *Agriculture in the European Union—Statistical and Economic Information*.

Figure 1.2: Number of agricultural workers

Sources: Ukraine data from National Bank of Ukraine; data on other countries from *Agriculture in the European Union—Statistical and Economic Information*.

of trying to dominate or dictate market outcomes, the government should establish and enforce the rules. What the market needs—and what farmers and all of agribusiness need—is a stable and consistent policy framework for the longer term. In such a policy environment, investment and operational decisions can be made with less risk and more confidence.

We could summarize our approach with a quotation by the famously successful Canadian hockey player, Wayne Gretzky: “I skate to where the puck is going to be, not where it is now.” We look ahead to the actions and directions that will make Ukraine’s agriculture and rural economy more productive and competitive in the global market of the future.

We refer several times in these chapters to “leapfrogging” opportunities for Ukraine. By this we mean that, in the spirit of the Orange Revolution, Ukraine does not have to follow the slow and ponderous path of the past or even of other countries. Leapfrogging means that Ukraine can and should immediately institute policies that other countries are struggling to move toward. The United States and the EU, for example, spent decades and billions of wasted resources supporting agricultural commodities, and we can see today how hard it is to break away from that addiction. While the EU struggles to move its support to more problem-oriented and region-ori-

ented targets over the next decade, Ukraine can institute a forward-looking agricultural and rural policy now.

The other general principle frequently cited in the following chapters is the need to target limited budget resources to real problems in agriculture and the rural economy, rather than subsidizing commodities. For example, investing in infrastructure, extension services, and market information systems that will facilitate farm and rural business activity is more valuable than direct farm subsidies. In many cases, targeting also suggests a place-based focus for support rather than a sectoral focus.

Although each chapter has a more detailed plan of action, the following list highlights the main action item for each. Hopefully, this will draw attention to their more detailed analyses and action recommendations.

1. *Agricultural support.* Support for agriculture must be for good infrastructure, stable markets, and a strong rural economy; any continued direct support must be decoupled from production of commodities.
2. *Land market.* Land owners must have full property rights and equal access to all markets and information.
3. *Rural development.* Rural problems cannot be solved with agricultural policy; rural policy should focus on good infrastructure, quality public services, good governance, a sound financial system, and diversification of employment and income opportunities.
4. *Decentralization.* Local governments must be empowered but accountable, with increased capacity, taxing authority, and decisionmaking responsibility, as well as strong anticorruption incentives.
5. *Agricultural taxation.* Taxation must be the same as for other industries, with concessions only for small and medium enterprises (SMEs).
6. *Agricultural regulation.* Regulation must set and enforce transparent rules, but not interfere with functions of the private market or impose excessively high regulatory costs.

The kind of bold action plan proposed by participants in the recent World Economic Forum Extraordinary Ukraine Roundtable (16–17 June 2005) is what is now needed for agriculture and rural development. In fact, the first action proposed was quick adoption of legislation for Ukraine to join the WTO. This is also essential for agriculture, as are many of the other actions proposed at the roundtable. The actions we propose will speed entry to WTO and prepare Ukraine for the competitive environment in the global market, including the EU.

Ukraine has rich endowments of human and natural resources. Rapid growth is possible if current barriers are removed. Since these barriers are mostly created by government action or inaction, their removal is not impossible. If the political will can be found to refocus agricultural and rural policy, the road ahead could be a very dynamic one.

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Reforming Agricultural Support

Sergiy I. Zorya

EXECUTIVE SUMMARY

Agricultural support remains the major topic of the agricultural policy agenda in Ukraine. Agricultural development is thought to almost fully depend upon agricultural support. This strong belief in the “magic effects” of support might be explained by the belief in the illusory success of socialist agriculture and a misunderstanding of the effects of rigorous state subsidies on farmers in OECD countries. The examples from countries with low agricultural subsidies—such as New Zealand, Australia, Argentina, or Brazil—are called irrelevant to Ukraine, though in these countries the farmers are not addicted to subsidies, and agriculture is characterized by greater competitiveness, lower input costs, higher diversification, and more adaptable farms that respond to market needs.

Among policymakers in Ukraine, there is almost universal agreement that agricultural support is extremely low. This is true when we compare the absolute value of subsidies per hectare of agricultural land in Ukraine with, for example, those in the United States and the EU. However, such a comparison is illogical, because we are comparing countries with unequal incomes. Ukraine's per capita GDP is only 4 percent of the per capita GDP of these countries.¹ Nevertheless, during 2001–03, Ukraine spent 1.51 percent of GDP on agricultural subsidies, while the shares were 0.73 percent in the United States, 0.65 percent in the EU, 0.51 percent in Canada, and 0.31 percent in Australia. Moreover, some agricultural producers in Ukraine received transfers from consumers due to higher farm-gate prices on meat and sugar, which exceeded the reference border prices. Thus, agricultural support in Ukraine is considerable.

Ukrainian agricultural producers are supported by direct budget subsidies, tax privileges, high import tariffs, a sugar quota, pledge prices, and administration of input prices during harvest and spring field operations. So far, the efficiency of agricultural support in Ukraine is low. Agricultural support stimulated the growth of agricultural output, agricultural GDP, and nominal farm wages. But success in stimulating nominal targets was nullified by a decline of farm wages relative to wages in industry. Farm wages in 1996 comprised 60 percent of average industry wages, but in 2004 the share decreased to 40 percent. The relation between farm support and real farm incomes is not unique in Ukraine. World experience conclusively demonstrates that in countries with high farm support, farm

¹ In 2004 the GDP of the city of Hamburg was US\$90 billion, compared to Ukraine's GDP of US\$65 billion.

incomes significantly lag behind nonfarm incomes, mainly because high subsidies distort incentives to competition and efficiency. In the countries with moderate agricultural support, the gap between farm and nonfarm incomes is negligible. Moreover, the latter countries succeeded in preserving absolute agricultural employment over the last 30 years, while in the countries with high agricultural support, agricultural labor has been replaced by subsidized capital.

The conclusion for Ukraine is that agricultural support may either stimulate or hamper agricultural development. No government in the world could mobilize enough budget resources to fully satisfy the needs of farmers and rural dwellers. But a responsible government can spend scarce resources efficiently to stimulate increased private investments in agriculture and minimize the negative effects of farm support on the rest of the economy. Based on these observations, the major reasons for low efficiency of agricultural support in Ukraine are the following:

- Agricultural policymakers continue following goals that are more relevant to centrally planned than market economies. We currently observe the support of gross outputs, food self-sufficiency, direct interventions into markets, and social support of rural dwellers by means of agricultural policy. To stimulate agricultural development, this support must be shifted to facilitate increased productivity, greater food security at the household level, and market stabilization.
- Agricultural policy often has been a substitute for social policy, which is why serious structural reforms in the sector are delayed. Large agricultural enterprises are almost fully exempt from taxes, and they receive budget subsidies. In exchange, they are expected to provide social services and remain responsible for rural development. It is interesting that many policymakers wonder why domestic farmers remain uncompetitive compared to overseas farmers, who do not play the role of rural councils and service suppliers.
- The design of support measures often remains inadequate to enhance agricultural competitiveness and account for new roles of farmers in the agrifood market chains. The government persistently tries to regulate the market. Price support mechanisms are developed based on the “cost plus” approach (production costs plus guaranteed margin), where farmers are expected to dictate to consumers the quality, quantity, and prices of food. In a market economy, however, agricultural price formation moves from consumers to farmers. Farm-gate prices are derived from consumer preferences, world market prices, retail costs, processing costs, retail and processing profits, and costs of collecting and transporting agricultural products. In this environment, if farm production costs exceed derived farm-gate prices, the farmer must either reduce costs or produce other products. By supporting farm prices, the state does not help these farms, but rather hampers competitiveness and structural change.
- There is no institutional support for agricultural development. Ukraine lacks a functioning agricultural land market, effective bankruptcy procedures, transparent pricing mechanisms, and supporting regulations. The state disperses resources to a large number of research and education institutions and food safety agencies, which do not produce the technology and services urgently required by the market.
- Many support measures create uncertainty in the market and undermine trust in state programs. Announced programs are implemented only partially or not at all. Actual budget

expenditures are often lower than promised in the budget. Farmers eligible to obtain subsidies sometimes do not receive them because of limited financing or unfavorable timing. Moreover, some measures are announced even when they cannot effectively be implemented, such as minimum prices.

- The efficiency of agricultural support is constrained by policy failures such as export taxes, regional barriers to trade, debts on export VAT refunds, and excessive regulatory costs. Since farm-gate prices are derived from market factors, all these measures lead to lower farm prices and discourage competition in the agribusiness sector. On the one hand, the state provides subsidies to farms; on the other, it indirectly taxes them through these short-sighted policy tools.
- Currently, many support mechanisms are not compatible with Ukraine's intention to join the WTO and convince the EU to begin the negotiations on an association agreement. For example, in the event that Ukraine becomes a WTO member, minimum prices—if they exceed reference border prices—become useless policy instruments. Price support of sugar and meat producers will also no longer be sustained. Still, WTO membership and starting on the path to EU membership could speed up the development and competitiveness of Ukrainian agriculture.

To realize Ukrainian agricultural potential, agricultural policy must urgently do the following:

- Become a coordinator that develops and enforces the rules by which private and state sector participants interact along food chains.
- Take urgent actions to join the WTO and facilitate progress on an association agreement with the EU, while taking into account the policy constraints, the opportunities of WTO membership, and Ukraine's path toward EU membership.
- Redirect scarce budget funds from commodities to problems and people. In other words, shift budget expenditures from stimulation of commodity production to financing of public goods provision and establishment of supporting legal, administrative, and regulatory systems to stimulate increased private investment in agriculture. Any continued direct farm supports should be transformed into decoupled income support.
- Begin structural reforms in state agricultural research and education institutions, consolidate food safety agencies to avoid duplication, and shift many of their responsibilities to the private sector. Increased financing of these public institutions must be conditioned on corresponding institutional reforms.
- Remove obvious handicaps to agricultural development such as export taxes, regional barriers to trade, control over food prices, debts on export VAT refunds, and excessive regulatory costs. Ensure the stability and the predictability of agricultural policy, and avoid announcing state programs that cannot be implemented.
- Address the problems of small subsistence farms, and distinguish between agricultural and social policies.
- Improve the analytical capacities of the Ministry of Agricultural Policy and other public agencies to ensure that up-to-date applied market and policy analyses are available to policymakers. Technical assistance from foreign donors is desirable to help build these capacities.

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Introduction

Agricultural support remains the major topic of agricultural policy agenda in Ukraine. Many policymakers and even academicians continue making Ukraine's agricultural and rural development almost fully dependent upon state support. This strong belief in the "magic effects" of agricultural support has two main antecedents. First, Soviet agriculture was intensively subsidized, and at the end of 1980s the share of subsidies in farm gross incomes in Ukraine reached 78 percent.² Thanks to these huge subsidies and so-called "benefits of the centrally planned economy" such as fixed prices, prescribed outputs, cheap credit, soft budget constraints, predefined input suppliers and food processors, as well as subsidized consumer prices, the gross agricultural output at that time greatly exceeded current production levels. Despite the low economic efficiency of state and collective farms and extremely distortive nature of the above "benefits" for the market economy, Soviet agriculture and its generous support have remained the example of the "successful Ukrainian model." Based on this perception of the role of subsidies in agricultural development, the Ukrainian government has only marginally reformed the agricultural sector, while continuing to spend public funds in unreformed agriculture without a clear overall strategy for the sector's development.

Second, most market economies provide generous support to their farmers and rural areas. This is especially true in OECD countries, where the farmers in 2003 received US\$257 billion of support (OECD 2004). Based on this information, and especially that from the EU Common Agricultural Policy (CAP), Ukraine's policymakers believe that sustainable agricultural development is hardly imaginable without comparable agricultural support; they also believe that the rules of competitiveness should not apply to Ukrainian agriculture as they should to other sectors. The examples of countries with low farm support—such as New Zealand, Australia, Argentina, and Brazil—are called irrelevant to Ukraine, though in these countries agriculture does not depend on subsidies and is characterized by greater competitiveness, lower input costs, and more diversified and adaptable farms that respond to market needs. Again, although the agricultural and structural reforms in these countries may contain valuable lessons, Ukraine's agricultural policymakers ignore this experience, picking the politically easier approach of "helping" agriculture through subsidies.

This report suggests the reform of agricultural support in Ukraine to enhance agricultural competitiveness, lower the dependence of farms on subsidies, direct scarce public funds to the most efficient use, limit the unintended negative effects of state support, and ensure fair standards of living for farmers under the constraints of WTO and EU membership. The next section discusses current goals of agricultural support in Ukraine and suggests some adjustments. This is followed by an international compari-

2 According to the World Bank and OECD (2004), the producer support estimate (PSE) in 1986–88 was 78 percent. At that time, the PSE in the United States was 25 percent, in the EU 39 percent, in Canada 35 percent, in New Zealand 11 percent, and in Australia 8 percent (see table 2.4). The methodology of the PSE and other support indicators' calculation is briefly presented later in this report. For details of these methodologies, see OECD (2004) in English and Zorya (2005) in Ukrainian.

son of Ukraine's agricultural support. Following that is an ex-post evaluation of current agricultural support in Ukraine. The next section estimates the efficiency of this support, and following that is a description of the major bottlenecks impeding this efficiency. The chapter concludes with a discussion of policy options and their consequences.

Appropriate goals of agricultural support

Clearly defined and well-developed goals of agricultural support play an important role in directing the government's scarce resources to their most efficient use in the market economy, e.g., provision of public goods and facilitation of efficient operations of the private sector. So far, Ukraine does not have an official conceptual document describing main goals or overall strategy and vision of the role of agricultural policy in agricultural and rural development. The best efforts to define the economic goals of agricultural support are made in the draft law "On Main Fundamentals of State Agricultural Policy in Ukraine" (June 2004), which specifies the following goals of agricultural policy:

- guarantee food security
- improve farm competitiveness, both domestically and internationally
- preserve the peasantry as a bearer of Ukrainian culture and national spirit
- develop rural areas and solve main social problems

These goals are similar to key objectives of agricultural policy worldwide, as proposed by the World Bank (2005, 12):

- improved productivity and competitiveness
- reduced rural poverty
- enhanced household food security
- increased capital accumulation by poor rural households
- more sustainable management of natural resources

The EU formulated its objectives and general principles of the CAP in the Treaty of Rome in 1956 as follows:

- increase agricultural productivity by stimulating technical progress and ensuring the rational development of agricultural production and the optimum utilization of the factors of production, in particular labor
- ensure fair standards of living for the farming population, in particular by increasing the earnings of persons engaged in agriculture
- stabilize markets
- assure availability of food suppliers
- ensure that supply reaches consumers at reasonable prices

Despite having similar agricultural policy goals as the EU and the World Bank, the Ukrainian government has so far followed other goals—more appropriate to meeting the requirements of a centrally planned rather than market economy. The overriding strategy for Ukraine's government should be creation of an enabling environment for the transition from a high on-farm employment, low wage, uncompetitive sector to low on-farm and high off-farm employment, high wage, and competitive agricultural sector. Table 2.1 summarizes major differences between economic goals of agricultural policy designed for planned and market economies.

Ukrainian agriculture has inherited many negative features of socialist agriculture. The centrally planned environment was, of course, the main cause of inefficiency of Soviet agriculture:

Central planning insulated the farms from market signals, imposed plan targets as a substitute for consumer preferences, and allowed farms to function indefinitely under soft budget constraints without proper profit accountability. Efficiency was never an objective in socialist agriculture: meeting production targets at any cost was the main priority. (Lehrman, Csaki, and Feder 2004)

D. Gale Johnson (1982) also noted that “in most centrally planned economies the policy setting of socialized agriculture can hardly be described as supportive of a low-cost and efficient agriculture.”

Although the government as a whole and the Ministry of Agricultural Policy of Ukraine in particular have made efforts to improve conditions for development of the agricultural sector, most of these policies have largely failed to tackle the productivity gap and distinguish between agricultural and social policies. According to Demyanenko and Kuhn:

The reason for this is that the implicit goals of this policy have not been targeted at productivity increases, but rather at sustaining existing farm structures and procedures by granting aid and tax breaks to producers, and attempting to control prices and quantities on output (e.g., grains, sunflower seed, and sugar) and input (e.g., machinery and credit) markets. Import protection for farm machinery, for example, may provide support to the domestic farm machinery industry. But it also forces farmers to pay more for the machines that they need (or to work with lower quality machines than they otherwise could). In this way, the productivity, and thus income gap, is sustained. (2004, 70)

The government has pursued the food self-sufficiency policy using prohibitive import tariffs, nontariff barriers, and export and regional sales barriers. Although high protection has encouraged greater food self-sufficiency through import substitution and higher domestic food production, it has certainly aggravated food security problems due to higher consumer prices, lower long-term farm competitiveness, and a larger tax burden on nonfarm taxpayers. In addition, high import tariffs have caused substantial

Table 2.1: Goals of agricultural policy in planned and market economies

Centrally planned economy	Market economy
Maximization of gross agricultural output	Improvement of agricultural productivity
Collective organization of production	Private farms with transparent relations with hired labor
Lifetime employment for farm members	Reduction of the gap between farm and nonfarm incomes
Social support of rural population by means of agricultural policy	Increase of agricultural competitiveness and social support of rural needy; alleviation of rural poverty
Direct price interventions	Market stability
Food self-sufficiency	Food security at household level
Rural development based on collective farms	Development of rural areas
Intensive use of natural resources	Sustainable management of natural resources

Source: author.

price fluctuations between good and bad grain harvests, encouraging the use of administrative control measures. While farmers receive tax breaks and some subsidies on the one hand, they are indirectly taxed by export taxes, low purchasing power of consumers, macroeconomic misbalance due to farm support, and bureaucratic “monitoring and control” of markets on the other.

Agricultural support in Ukraine is designed to stimulate large-scale agricultural production. Small-scale households and private farmers remain ignored, though they produce more than half of gross agricultural production. Small farms lack access to credit, state subsidies, and developed infrastructure to expand to competitive size. While it is commonly agreed that small subsistence farms are not commercially viable and cannot ensure the efficient production of safe and high-quality agricultural products—especially in anticipation of moving toward the EU with its strict cross-compliance and sanitary and phytosanitary (SPS) standards—proactive small farmers must have the chance to expand, and large-scale farms should downsize in terms of number of workers and land to become more efficient.

Finally, agricultural policymakers continue to pursue rural development policy based on large farms. Such an approach hampers the commercialization of agricultural enterprises, encourages the cross-subsidization of small households by large farms, and preserves the vacuum of rural self-organization and development of rural territories.³

³ See chapter 4.

The failure and unsustainability of many of these programs should lead to a rethinking of the goals of agricultural policy and the role of the state in Ukraine's agricultural sector. No government in the world has the financial resources to satisfy all the needs of agricultural producers and rural dwellers. But wise governments spend their scarce resources to scale up private investments and credits into agriculture by providing public goods and supporting the private sector with adequate legislation and regulations.

International comparison

The agricultural sector is subsidized worldwide. Before we consider agricultural support in Ukraine, it would be interesting to compare its magnitude to that in other countries. The OECD's producer support estimates (PSE) and total support estimates (TSE) allow international comparison of farm support among developed and several middle-income economies.⁴ The PSE is an indicator of the annual monetary value of transfers from consumers and taxpayers to support farmers. It is measured at the farm-gate level and arises from policy measures that support agriculture, regardless of their nature, objectives, or impacts on farm production or income. The PSE consists of market price support (transfers from consumers) and budget payments (transfers from taxpayers). The TSE includes all gross transfers from taxpayers and consumers, including the general service support measures ("green box" measures), net of associated budgetary receipts from import tariffs.

While it might be interesting to compare the absolute support indicators among countries, they are often misleading, especially for countries with significant income differences. For example, in 2004 Ukraine's GDP was US\$65 billion, while the GDP of only one German city, Hamburg, was US\$93 billion. Hence, it is useful to compare the subsidies per hectare in absolute terms, e.g., between the EU and the United States, but not between Ukraine and the EU. Table 2.2 provides additional proof: it includes the data on nominal GDP, per capita GDP, and per capita GDP at purchasing power parity (PPP) exchange rates in selected high- and middle-income countries. Ukraine's per capita nominal income is only 4 percent of those of Germany and France, and only 2 percent of that in the United States. Even accounting for the different PPP, Ukraine's per capita income increases to 18 percent of those of Germany and France and 13 percent of that of the United States. Differences in purchasing power result in the situation where US\$100 per hectare is worth much more to a Ukrainian farmer than to U.S. or even Polish farmers. A farmer in the United States would have to receive US\$572 per hectare, and a Polish farmer US\$216 per hectare, to receive the comparable benefits that a Ukrainian farmer would get from US\$100.

Hence, we use mainly relative indicators to make international comparisons of farm support plausible and useful. Instead of using the PSE and TSE, we will use the percentage PSE and TSE. The percentage PSE is defined as a share of the PSE in the value of total gross farm receipts, measured at farm-gate prices, plus budgetary support. The

4 Data for Ukraine appeared in 2004.

Table 2.2: GDP measured using different methods in selected countries in 2002

Countries	Nominal GDP, in US\$ billions	Per capita nominal GDP, in US\$	Per capital GDP at PPP exchange rate, in US\$*	PPP exchange rate**
United States	10,383	36,006	35,750	0.99
Germany	1,984	24,051	27,100	1.13
France	1,431	24,061	26,920	1.12
Australia	409	20,822	28,260	1.36
New Zealand	59	14,872	21,740	1.46
Poland	189	4,894	10,560	2.16
Argentina	102	2,707	10,880	4.02
Russia	347	2,405	8,230	3.42
Ukraine	42	851	4,870	5.72

Source: UNO Development Program (<http://hdr.undp.org>).

Notes: * PPP exchange rate measures how much a currency can buy in terms of an international measure (usually dollars), since goods and services have different prices in some countries than in others. PPP exchange rates are used in international comparison of standards of living.

** PPP exchange rate is defined as a ratio of per capita nominal GDP to per capita GDP at PPP.

percentage TSE is defined as a share of total support to agriculture in the total GDP.⁵ Table 2.3 compares the PSE and the percentage PSE in Ukraine and several countries. In the Soviet era, Ukrainian (and Russian) agriculture was significantly subsidized, i.e., 78 percent of the farm gross income originated from various support measures. Domestic farm-gate prices were 6.6 times higher than reference border prices. This meant that farmers received 4.6 times larger incomes than they would have at world market prices. It is fully understandable why, after the breakup of the Soviet Union, the sharp reduction in farm support caused the dramatic drops in farm output and income. In the Soviet Union, agricultural producers did not orient themselves to consumer demand, but rather to prescribed output plans and subsidies that disconnected them from final consumers.

In the course of the transition, agricultural support in Ukraine fell greatly; during 2001–03, the percentage PSE was zero. While this is comparable to Australia and New Zealand, it is much less than in the EU and North America. At the same time, the average percentage PSE in Ukraine hides a substantial variability of product-specific support. During 2001–03, the percentage PSE of poultry meat producers reached 44 percent, sugar producers 30 percent, and other meat producers 8–15 percent (figure 2.1). Regrettably, producers of milk, sunflower seeds, and eggs were severely taxed. Again, figure 2.1 demonstrates the danger of possible manipulation of average figures, such the average PSE, in Ukraine.

5 See details in Zorya (forthcoming).

Table 2.3: PSE and percentage PSE in selected countries, 1986–2003

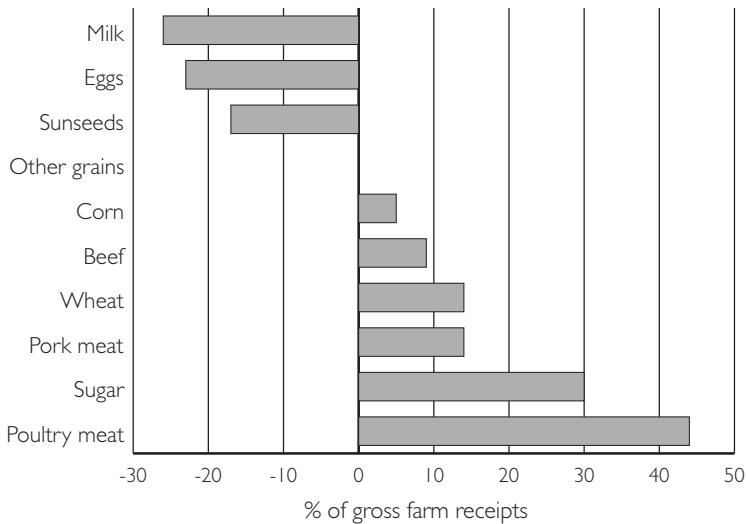
	1986–88	2001–03	2001	2002	2003
Ukraine					
PSE in million UAH	35,840	10	2,429	–3,079	679
Percentage PSE	78	0	4	–5	1
Australia					
PSE in million Australian dollars	1,264	884	792	844	1,016
Percentage PSE	8	4	3	4	4
New Zealand					
PSE in million New Zealand dollars	474	114	31	122	189
Percentage PSE	11	2	0	2	2
Canada					
PSE in million Canadian dollars	5,667	4,675	3,949	4,514	5,563
Percentage PSE	34	19	17	20	21
United States					
PSE in million US dollars	41,831	44,239	52,991	40,849	38,878
Percentage PSE	25	20	23	19	18
EU					
PSE in million Euro	95,611	101,696	88,926	94,789	121,371
Percentage PSE	39	35	34	35	37
OECD average					
PSE in billion US dollars	241	238	228	230	257
Percentage PSE	37	31	31	31	32
Russia					
PSE in million Russian rubles	117,275	57,437	74,280	89,573	8,460
Percentage PSE	81	6	9	9	1

Source: OECD (2004).

Based on the PSE methodology, Ukraine's average PSE is very low. Why? Note that the PSE consists of market price support (consumer transfers) and budget support (taxpayer transfers). If the budget support is positive but total PSE zero, farm-gate prices are lower than reference border prices, meaning that farmers are, in effect, taxed by low prices (table 2.4).⁶ If we recalculate the percentage PSE based on only budget

⁶ This taxation can occur not only due to policy interventions such as export tax, but to market inefficiencies as well.

Figure 2.1: Percentage PSE in Ukraine for selected agricultural products, 2001–03 on average per year



Source: World Bank and OECD (2004).

Table 2.4: Structure of PSE in Ukraine and other countries, in millions of national currency, 2001–03, average per year

	Ukraine	Australia	Canada	USA	EU	Russia
Market price support (MPS)	-3,814	6	3,383	1,6836	58,311	37,853
Budget transfers	3,824	1,546	3,619	2,7403	44,397	19,584
PSE	10	1,552	7,002	4,4239	102,708	57,437
Percentage PSE	0	4	19	20	35	6
Percentage PSE (without MPS)	6	4	10	12	15	2

Source: OECD (2004).

transfers, Ukraine's PSE grows to 6 percent. In this case, Ukraine's PSE exceeds Russia and Australia's and is close to Canada's.

Since the agricultural producers benefit not only from sector-specific subsidies, but also from general services such as provision of public goods and supporting legislative, administrative, and regulatory environment, the OECD estimates the TSE. Table 2.5 shows the structure of TSE and its percentage of GDP in several countries. Again, looking at the classical percentage TSE, we see that Ukraine spends only 0.29 percent

Table 2.5: TSE in selected countries, in millions of national currency, 2001–03, average per year

	Ukraine	Australia	Canada	United States	EU	Russia
Producer support estimate	10	1,552	7,002	44,239	102,708	57,437
General services support estimate	657	909	2,455	27,159	9,410	17,735
Total support estimate	667	2,249	9,485	95,128	115,879	75,112
(1) Transfers of consumers	–2,206	4	3,579	18,914	56,235	87,377
(2) Transfers of tax payers	3,879	2,246	6,161	78,295	60,342	95,414
(3) Budget incomes from import tariffs	–1,006	–1	–255	–2,018	–698	–107,619
Share of TSE in GDP, %	0.29	0.31	0.82	0.91	1.27	0.68
Share of TSE (without consumer transfers) in GDP, %	1.51	0.31	0.51	0.73	0.65	–0.64

Source: OECD (2004).

of GDP, which is much lower than in the EU, United States, Canada, and even Russia. However, when we deduct negative consumer transfers from and make correspondent adjustments to other countries' TSEs, the share of total farm support in Ukraine's GDP grows to 1.51 percent, which is at least as much as in the EU and United States.

We conclude that despite the low level of farm support under the classical OECD methodology (mainly due to low prices for milk, grain, and sunflower seeds), Ukraine's farm budget support, combined with large market price support for meat and sugar producers, remains comparable to that in rich OECD countries. Moreover, Ukraine spends the largest share of total GDP on farm support among comparable OECD countries. Therefore, it is wrong to think that farm support in Ukraine has been low. The problem is that budget transfers are neutralized by low farm-gate prices and institutional inefficiencies. Moreover, how budget support is provided does not meet the needs of modern agriculture based on private property.

Review of current agricultural support mechanisms in Ukraine

The agricultural sector can be supported by different policy mechanisms. In terms of farm support in Ukraine, policymakers speak mainly about direct budget transfers and

tax privileges. At the same time, the hidden support through high import tariffs, persistent nontariff barriers, and production quotas that lead to large consumer transfers to agricultural producers is often underemphasized. Below we make a brief ex post analysis of agricultural support in Ukraine in recent years, distinguishing between budget transfers, tax privileges, import protection, production quotas, and administrative control of input prices.

Budget transfers

Budget transfers to agriculture and rural areas grew from UAH1.4 billion in 2002 to a planned UAH4 billion in 2005 (table 2.6). Agricultural expenditures as a percentage of total budget rose from 2.3 percent in 2002 to 3.5 percent in 2005.⁷ Under the WTO classification, 30 percent (or UAH1.1 billion) of budget expenditures belong to the “amber box,” which is subject to reduction commitments due to its negative distortive effects on trade and production. These measures (1–8) aim to support either production of specific agricultural outputs such as beef, pork meats, horticulture, and wine grapes; or subsidize the costs of commercial credits, fertilizers, and agricultural machinery. According to the Ministry of Agricultural Policy, the bound aggregate measurement of support (AMS) is expected to equal US\$1.14 billion (roughly UAU 5.7 billion at current exchange rates). If Ukraine succeeds in binding its AMS at this level, it will create substantial room, assuming other factors (such as exchange rates remaining stable), to enable future increases of farm support measures belonging to the “amber box.”

In addition to budget expenses from the “amber box” creating distortive negative effects on agricultural production, trade and food consumption, agricultural budget support also suffers from the following problems: absence of a long-term financial plan, underfinancing of planned programs, wrong-time allocation of budget funds, and limited budgets of some programs. First, there is no long-term strategy for use of the agricultural budget in Ukraine. The budget articles lack continuity, varying greatly over the years from zero to hundreds of millions. This makes long-term planning, and thus investment plans for farmers, extremely difficult. Second, state support creates the wrong incentives, because actual expenditures on some programs have been regularly lower than promised in the budget. For instance in 2004, the crop selection program was underfinanced by 20 percent, the subsidy for fertilizers by 30 percent, and spring field costs compensation by 70 percent.⁸ Third, from year to year the Ministry of Finance provides only 5 percent of total agricultural subsidies in the first quarter, but over 50 percent in the last quarter, and 35.8 percent in December. This does not take into account the highest need for funds in the first quarter. Fourth, some programs lack financing to ensure the participation of all farmers. For example, agricultural producers receive the subsidy when they slaughter cattle of up to 390 kg. In 2005, the minimum weight of cattle supplied from small private households was

⁷ Planned budget expenditures in 2005 are UAH114 billion.

⁸ APK-Inform from April 4, 2005.

Table 2.6: Budget transfers to agriculture in Ukraine, in UAH millions, 2002–05

	2002	2003	2004	2005
Support measures from the “amber box”				
(1) Reduction of costs of commercial credit	119.6	13.4	141.5	350.0
(2) Financial support of small private farms	4.5	39.3	5.1	27.3
(3) Financial support of crop and livestock production	73.9	2.0	421.0	689.5
(4) Support of horticulture, wine grape and hops production	118.1	5.0	109.1	175.0
(5) Partial compensation of costs of agricultural machinery and fertilizers	35.9	37.8	393.7	270.0
(6) Financial support of dairy processors	0	0	0	10.0
(7) Pledge grain operations	0	69.9	0	0
(8) Agrarian fund	0	0	0	6.0
Support measures from the “green box”				
(9) Research and education	146.6	295.1	61.8	113.0
(10) Pest and disease control	37.2	140.4	86.3	131.4
(11) Crop selection and livestock breeding	25.6	238.2	152.7	224.0
(12) Consultancy	1.3	4.0	7.9	16.3
(13) Inspection services related to food quality and safety	397.8	375.4	606.9	737.9
(14) Agricultural training and qualification improvements	385.4	458.8	603.1	881.5
(15) Land reform	0.2	3.6	1.8	5.0
(16) Rural infrastructure	7.9	25.4	15.6	17.0
(17) Environmental protection	8.9	0.7	24.4	26.5
(18) Agricultural insurance	0	0	0	54.0
(19) Public food reserves	19.2	30.3	50.0	25.9
(20) Natural disaster relief	1.6	693.3	67.3	20.0
(21) Other expenditures	14.1	285.9	203.8	189.5
Totals	1,397.8	2,718.5	2,952.1	3,967.8

Source: Institute for Economic Research and Policy Consulting of Ukraine (2005).

Note: Funds managed by the Ministry of Agricultural Policy of Ukraine. Data on 2005 is planned expenditures based on the amendments to the Law on State Budget of Ukraine (March 2005).

reduced to 300 kg, stimulating excessive slaughter of cattle. Since the budget will now not be enough to pay the subsidy to all producers, the state's inability to keep its promises continues to undermine trust in state policy.

The large share of "green box" measures has been a very positive feature of Ukraine's agricultural budget (table 2.6). The largest portion of "green box" funds is spent on agricultural training/retraining, research, inspection services related to food safety, and selection/breeding programs. At the same time, the extension services remain out of any national budget support, and the support on agricultural insurance remained nonfunctional. In general, the efficiency of most "green box" measures has been highly questionable, because private businesses in agriculture do not receive adequate support in the form of "public goods" from the public institutions. For this reason, we advise the Ukrainian government to increase financing of these public services only after they undergo serious reform.

Ukraine urgently needs to reform its research and professional training institutions to adapt new products and production methods to the country's conditions. At present a large number of agricultural research institutions fail to produce qualitative applied research, including adequate quantities of seeds and livestock breeds at competitive prices. The quality of specialists graduated from agricultural colleges and universities or who have participated in retraining courses lags far behind international standards. According to IER:

A perhaps symbolic but nonetheless telling symptom is that Ukraine does not have an active country group in the International (and European) Association of Agricultural Economists, which is certainly surprising considering the country's history and image as an agricultural powerhouse. (2002, 27)

About 20 percent of agricultural budget expenditures are allocated to food safety agencies. Increasingly stringent food safety and agricultural health standards in industrialized countries pose major challenges for Ukraine's entry into international markets for high-value products such as fruits, vegetables, fish, dairy, and meat. In general, "for those countries and suppliers who are well prepared, rising standards represent an opportunity; for those who are poorly prepared, they pose safety and market access risks" (ARD 2005). In Ukraine, however, instead of helping the private sector meet strict food safety and agricultural health standards, national food safety agencies often hamper private businesses through high transaction costs (expensive and lengthy certification and testing procedures), duplication of functions by multiple agencies (ministries of Agricultural Policy, Health Care, and Economy), corruption stimulated by loopholes in the Soviet GOST standards, and weak enforcement of food safety legislation. As in the agricultural research system, food safety agencies in Ukraine must be reformed to be proactive, to move beyond control functions to emphasize awareness-building on quality and safety management and facilitating individual or collective actions that can be taken by private companies, farmers, and others.

Table 2.7: Tax exemptions and privileges for Ukrainian agriculture, UAH millions, 2001–04

	2001	2002	2003	2004
Benefits from fixed agricultural tax	1,400	1,365	1,400	1,400
Exemptions from VAT sales of agricultural products	541	1,457	1,470	1,240
VAT returned to milk and meat producers	634	671	357	400
Totals	2,575	3,493	3,227	3,040

Source: World Bank and OECD (2004) and IER (2005).

Agriculture is a risky venture. Agricultural insurance is needed to mitigate some risks, but the agricultural insurance system needs some facilitation by the state. Therefore, it is included in the list of “green box” measures. In Ukraine, this facilitation was planned to be 50 percent compensation of agricultural insurance contributions of grain and sugar beet producers. But these funds were never disbursed, and it is not likely the UAH54 million budgeted for 2005 will be disbursed either (Nedashkovskaya 2005). The reason is the absence of clear regulatory legislation, which discourages private insurance companies from serving the agricultural sector. Instead of allocating useless funds on insurance compensation, the Ministry of Agricultural Policy should first invest money in the creation of an agricultural insurance agency, which will carefully study international experience and methods on loss and risk assessment, develop the mechanisms of insurance programs and regulation of insurance companies, create a centralized database, ensure access to international reinsurance markets, and train insurer personnel (Yakubovych 2005). The sustainability of agricultural insurance will greatly depend on the willingness and ability of Ukraine’s agricultural policymakers to seriously develop the agricultural insurance agency in collaboration with donors such as the International Finance Corporation, private insurance companies, and farmers.

Tax privileges

Since 1999, the agricultural sector has remained the largest beneficiary of tax exemptions and privileges in Ukraine. During 2001–04, farmers accumulated about UAH12 billion in such benefits (table 2.7). For comparison, during 2001–03, the industrial enterprises of automobile, airplane and ship construction, space, and metallurgic sectors together accumulated UAH900 million of various tax privileges, or only 8 percent of the benefits received by agriculture.⁹ In Ukraine, agricultural tax benefits are used

9 See *Investyziyna Gazeta*, April 2005, p. 8.

to substitute for low direct budget transfers, and in 2004 the benefits from tax exemptions equaled 75 percent of the total agricultural budget.

Tax benefits are excluded from the WTO domestic support reduction commitments due to their complexity, and thus the impossibility of correct evaluation in various countries. This means that Ukraine does not have to include tax benefits in its current AMS. Even if Ukraine were asked to consider the tax privileges as a part of domestic support, the fixed agricultural tax would have been included to the “green box,” since it is decoupled from production decisions. On the other hand, VAT exemptions are in the nature of the “amber box,” since the size of benefits hinges on quantities produced. But again, tax exemptions will not be added to the domestic support calculations relevant to the WTO.

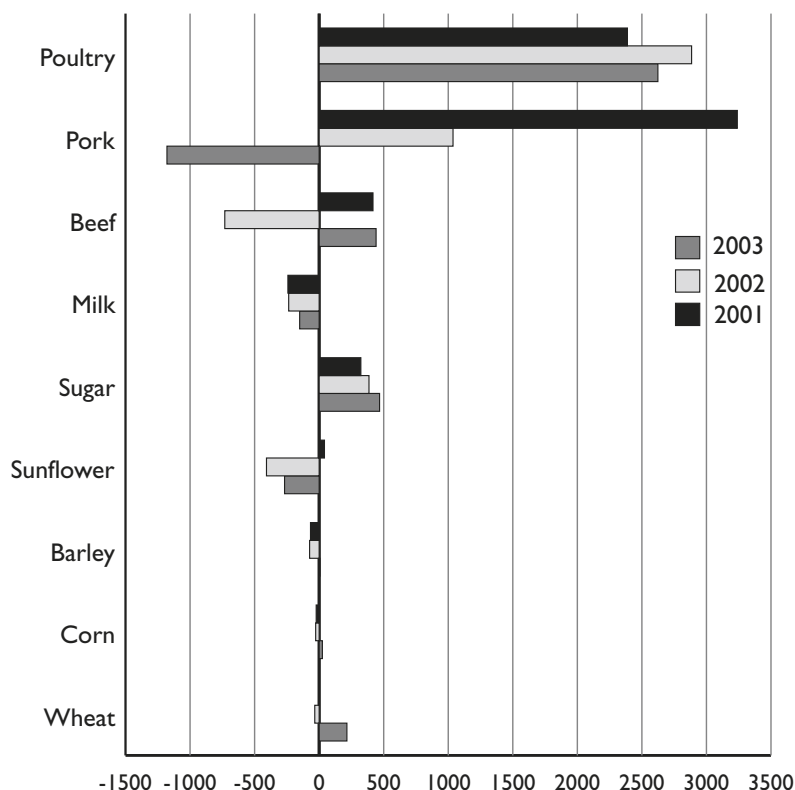
The only problem with VAT exemptions is that they discriminate against foreign goods. Under the nondiscrimination rule of the WTO, if there is zero VAT on milk and meat, import VAT on raw milk and meat should also be zero.

Import protection

Ukraine pursues an autarky policy using high import tariffs and nontariff barriers to trade. Over 60 percent of import tariffs for agrifood products are expressed in both ad valorem and specific terms. These mixed tariffs greatly increase effective border protection and the specific duties in ad valorem terms for sunflower, sugar and poultry meat are well above 100 percent. Import tariffs are kept prohibitively high for all domestically produced agrifood products. This leads to an artificial increase of agrifood prices especially those for which Ukraine is a net importer. Although in good harvest and/or production years the import tariffs are not binding for net export products, they inflate food prices in low harvest years (i.e., grain crises in 2000 and 2003) and lead to extreme price fluctuations (Brümmer and Zorya 2005).

Hence, high import tariffs combined with restrictive nontariff barriers—such as lengthy and nontransparent customs procedures as well as costly border veterinary, quarantine, and other SPS inspections—lead to increased transfers from consumers to producers through higher-than-market agrifood prices. Since the majority of consumers are not aware of this invisible taxation, it allows the pursuit of a farmer-oriented policy while reducing opposition from nonfarmers.

Figure 2.2 shows the differences between farm-gate and border reference prices of major agrifood products in Ukraine during 2001–03. With some exceptions for beef in 2002 and pork in 2003, Ukrainian consumers are charged high prices for all types of meat and sugar. But despite high prices, domestic production of sugar and meat are inadequate to satisfy domestic demand. The substantial increase of the population’s income in 2005 will inflate food prices further, since Ukrainian consumers are inclined to consume greater quantities of higher-value food while policymakers resist liberalizing food imports. The desire to encourage production of specific commodities such as meat will fail, because the public sector is not well

Figure 2.2: Differences between domestic farm-gate and border reference prices, UAH per ton, 2001–03

Source: World Bank and OECD (2004).

suited to picking commodities or production activities likely to be economically sustainable. Greater subsidization of meat production will just replace the crisis of low domestic production and high prices to a new crisis of high domestic production and low prices.

Production quotas

The Ukrainian government uses the sugar quota to support sugar beet and sugar producers through transfers from consumers. The sugar quota was introduced in 2000, and it emulates the EU system. However, it provides for no export subsidy on exportable surplus. The national marketing quota for sugar produced from domestic

sugar beets, as well as minimum in-quota prices for beets and sugar, are fixed annually. In 2002–04 marketing years, the quota was set at 1.8 million tons of sugar with a minimum price for white sugar at US\$455 per ton (CIF reference price for white sugar from Brazil and France ranges from US\$330–390 per ton).¹⁰ Taking into account that consumption of sugar in Ukraine is above 2 million tons, the loss of consumer welfare from sugar quota equals at least UAH800 million annually, or UAH3.2 billion during 2002–04.¹¹ Under WTO rules, consumer transfers to farmers due to administratively set prices within the sugar quota will be added to Ukraine's current AMS.

Pledge and minimum prices

To prevent the sharp decline in grain prices after the 2002 harvest, the “pledge price” system was implemented. This system aims at purchasing a certain amount of grain to the state storage at fixed price, granting grain owners the right to redeem their grain when the market price exceeds the guaranteed pledge price (plus storage costs). For many reasons, this system is inefficient. First of all, the pledge system could prevent sharp grain price falls only if the state guaranteed to purchase all grain surpluses. To make such a guarantee in 2004, for example, the budget would have had to allocate US\$614 million (or the total agricultural budget) compared with the less than US\$14 million allocated in 2003 (Kuhn and Niviyevskiy 2005). Second, the pledge prices were set at a low level, and no farmer will want to take advantage of a pledge price that is so low as to provide no or even negative support. Third, due to the low sustainability of the majority of state support programs in Ukraine and forced measures such as regional export bans, certification practices, and confiscation, the farmers avoid transactions with state programs.

To substitute for low budget allocations on pledge operations and inefficiency of this program, the Cabinet of Ministers set the minimum prices of grain and oilseeds for the 2005 harvest. Minimum prices were set higher than world market prices. For example, the minimum price of III class soft wheat is set at UAH690 per ton (US\$138), while the typical FOB Odessa export price is US\$100 per ton. According to the Minister of Agricultural Policy, traders and processors are obliged to purchase grain and oilseeds at least at these prices; otherwise they will be penalized based on Ukraine's law “On Prices and price formation” (APK-Inform 2005).

Such a decision illustrates a typical failure of the shortsighted agricultural policy of the last decade. The system of minimum prices produces many unintended effects, including higher feed costs, higher processing costs, higher consumer prices under prohibitive import tariffs, and discouragement of exports.¹² Moreover, it does not address the real cause of sharp price decline in the aftermath of harvest, i.e., high storage costs. Farmers not only have to pay high storage fees, they also face

10 See World Bank and OECD (2004).

11 This estimation is based on average price difference between domestic and world market sugar prices.

12 At this minimum price of soft wheat, Ukraine will not be able to export wheat without export subsidies.

uncertainty in quality tests at elevators. The state must properly certify the private elevators and monitor the use of monopoly power. But the policymakers continue undermining the reliability of state support. Moreover, the pledge and minimum price systems belong to the “amber box” and are subject to reduction commitments under WTO rules.

Administration of input prices

Finally, in recent years the Cabinet of Ministers has made attempts to set low prices for fuel and fertilizers before spring planting. The Cabinet has signed so-called “friendly memorandums” with fertilizer plants and diesel suppliers with simultaneous temporary export prohibition of these products. In 2005, for example, the fertilizer plants committed to sell 510,000 tons of different types of fertilizers at fixed prices, and diesel suppliers committed to supply 600,000 tons of diesel at UAH2.4 per liter. Although this policy was announced as temporary, it gradually became a permanent tool for keeping input prices at lower-than-market levels. In general, these programs addict policymakers to administrative tools of managing the economy, lead to economic losses for private fertilizer and fuel companies, increase uncertainty on input availability, and create incentives for fraud and resource misuse, e.g., resale of cheap diesel at free market prices.

Efficiency of current agricultural support in Ukraine

State support affects the performance of agricultural sector and farm incomes. In Ukraine, policymakers continue to use traditional indicators derived from socialist agriculture, e.g., output and nominal wage indicators as a measurement of success of subsidies and other agricultural policy measures. In a market economy, however, the most important indicators of agricultural success are change in agricultural productivity/efficiency, agricultural GDP relative to GDP of other sectors, and relative farm wages. Since we do not have the data on total factor productivity of Ukrainian farmers, we will present proxies for agricultural relative incomes.

Table 2.8 presents the statistical information on agricultural support, output indicators, agricultural GDP, GDP per capita in agriculture and outside of the sector, as well as income indicators. Agricultural support grew 1.5 times from 1996 to 2004, and total agricultural output and agricultural GDP grew threefold. Note that the gross agricultural output of large agricultural enterprises—the major beneficiaries of state support—increased only 2.2 times in nominal terms. Without far more detailed analysis, it is not possible to determine the various causal factors in the growth of agricultural GDP or output.

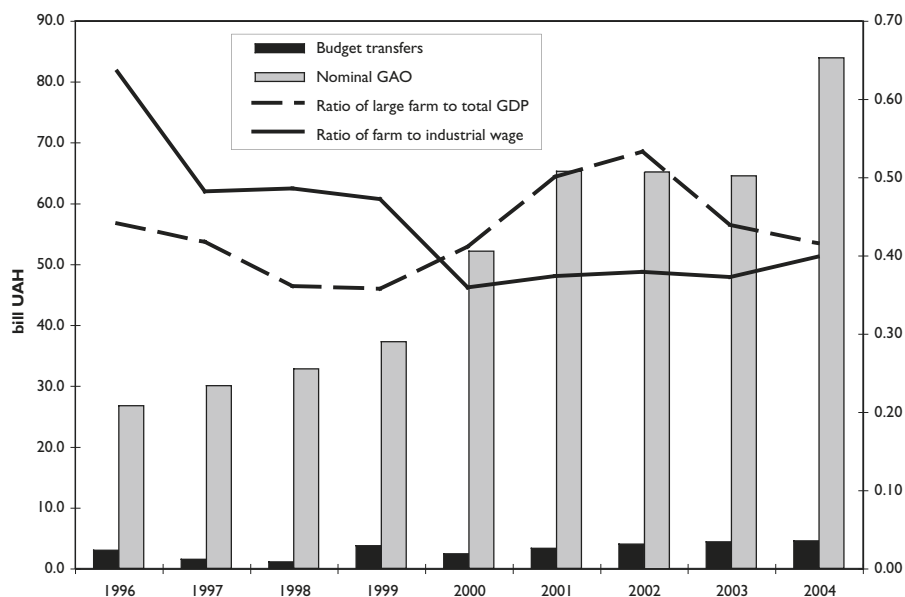
At the same time, the ratio of per capita agricultural GDP to per capita total GDP fell. In 1996, agricultural gross income was 60 percent of total income (as proxied by total GDP per capita), while in 2004 it declined to 49 percent. The agricultural gross income per capita of large enterprises in 2004 was only 41 percent of Ukraine’s total

Table 2.8: Budget transfers and key indicators of agricultural performance and income in Ukraine, 1996–2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Budget transfers, UAH billion	3.0	1.5	1.1	3.7	2.4	3.3	4.0	4.4	4.5
Output and GDP indicators									
Gross agricultural output (GAO), UAH billion	26.7	30.0	32.8	37.2	52.1	65.2	65.3	64.5	83.9
GAO of large farms, UAH billion	12.1	13.3	13.7	14.9	18.3	25.1	26.2	21.5	27.7
Changes of real GAO, %	–6.5	–1.7	–8.3	–7.4	9.8	10.2	1.2	–11.0	19.1
Share of agriculture in GDP, %	13.1	12.1	11.2	11.4	11.0	14.7	14.4	12.5	13.0
Agricultural GDP, UAH billion	10.7	11.3	11.5	14.9	18.7	30.0	32.5	33.0	45.0
Income differentials (per capita GDP)									
Agricultural GDP per capita, 1000 UAH	2.1	2.3	2.3	3.0	3.8	6.0	6.5	7.2	7.8*
Large farms GDP per capita, 1000 UAH	1.6	1.7	1.7	2.1	2.5	4.8	6.2	6.1	6.7*
Total GDP per capita, 1000 UAH	3.6	4.2	4.6	6.0	8.0	9.7	10.6	12.3	16.1*
Ratio of agricultural to total GDP per capita	0.60	0.56	0.50	0.50	0.48	0.62	0.62	0.58	0.49*
Ratio of large farm to total GDP per capita	0.44	0.42	0.36	0.36	0.31	0.50	0.59	0.50	0.41*
Wage indicators									
Farm wage, 1000 UAH per year	1.1	1.0	1.1	1.2	1.3	1.8	2.2	2.6	3.5
Industrial wage, 1000 UAH per year	1.8	2.1	2.2	2.6	3.7	4.9	5.8	7.1	8.9
Average economy wage, 1000 UAH per year	1.5	1.7	1.8	2.3	2.8	3.7	4.5	5.6	7.1
Ratio of farm to industrial wage	0.63	0.48	0.48	0.47	0.36	0.37	0.38	0.37	0.40
Ratio of farm to total wage	0.76	0.59	0.58	0.54	0.48	0.49	0.49	0.47	0.50

Source: NBU (2005) and World Bank and OECD (2004).

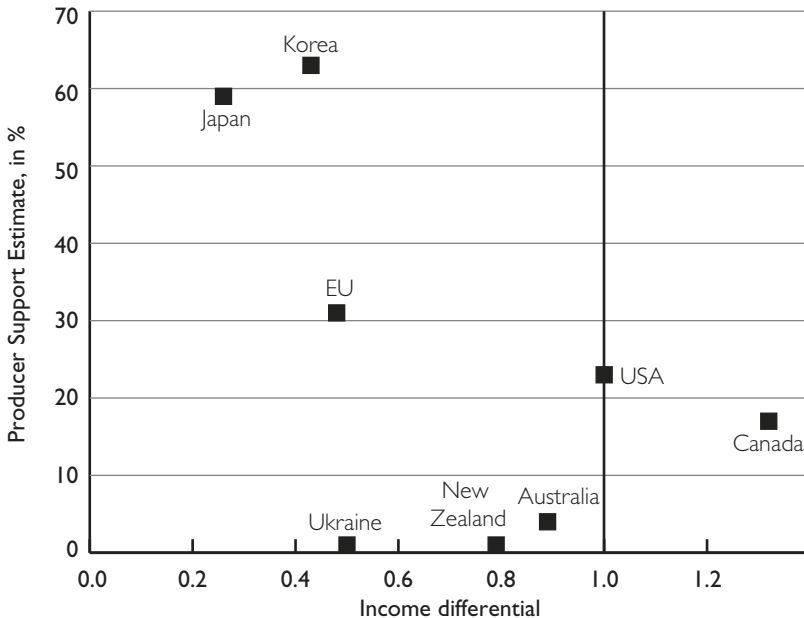
Note: * Due to lack of official data, agricultural and total employment in 2004 is assumed to equal that in 2003.

Figure 2.3: Absolute and relative indicators of farm performance in Ukraine, 1996–2003

Source: NBU (2005) and World Bank and OECD (2004).

per capita income. During the observed period, farmers experienced a broadening of the gap between agricultural and nonagricultural wages. In 1996, the average farm wage equaled 60 percent of the average industrial wage, and in 2004 it declined to only 40 percent. Figure 2.3 illustrates the improvement of absolute performance indicators versus the decline in real farm incomes.

This relationship of high farm support and low farm real income is not untypical in world agriculture. All over the world, improperly designed and implemented agricultural support discourages farm competitiveness, economic growth, and farm incomes. Figure 2.4 clearly shows the negative correlation between agricultural support and farm income differentials in selected countries. The countries with relatively low PSE (Australia, New Zealand, United States, and Canada) are more successful in reducing the gap between farm and nonfarm incomes. The most protectionist countries such as Japan, Korea, and the EU are lagging well behind in farm income parity. New Zealand, with its PSE of 1 percent, provides much higher real income for farmers than does the EU with a PSE of 34 percent, or Japan and Korea with PSEs of 60 percent. In spite of the fact that the PSE in Ukraine is similar to those in New Zealand and Australia, income differentials in Ukraine are typical for

Figure 2.4: Farm support and income differentials in selected countries in 2002

Source: Author, based on OECD (2004) and FAOSTAT (2005).

Note: Income differential is defined as per capita agricultural GDP divided by total per capita GDP.

countries with inefficient agricultural systems (despite high levels of support). Hence, when the state wishes to provide state support to reach certain policy goals, such as a reduction of the gap between farm and nonfarm incomes, proper policy mechanisms should be employed. Otherwise the goal will never be attained and farmers will only become addicted to subsidies.

And final evidence of the ineffectiveness of generous farm support on keeping labor in agriculture is summarized in table 2.9. This data shows the change in agricultural employment in selected OECD countries from 1970 to 2000. We see that in countries with very high farm support (EU and Korea), agricultural employment fell substantially in absolute and relative terms. The acceleration of labor outflows from agriculture was caused by the faster substitution of labor by subsidized capital, and the increased land capitalization due to farm support (and thus, the growth of entry costs for new farmers). In the United States, the reduction of the absolute number of farmers was slower than in high-support countries. And in Australia, and especially in New Zealand, we observe even the increase of agricultural employment in absolute terms. In these countries, agricultural employment has declined as a share of total employment, but these countries have succeeded in preserving absolute agricultural

Table 2.9: Agricultural employment in selected OECD countries, 1970–2000

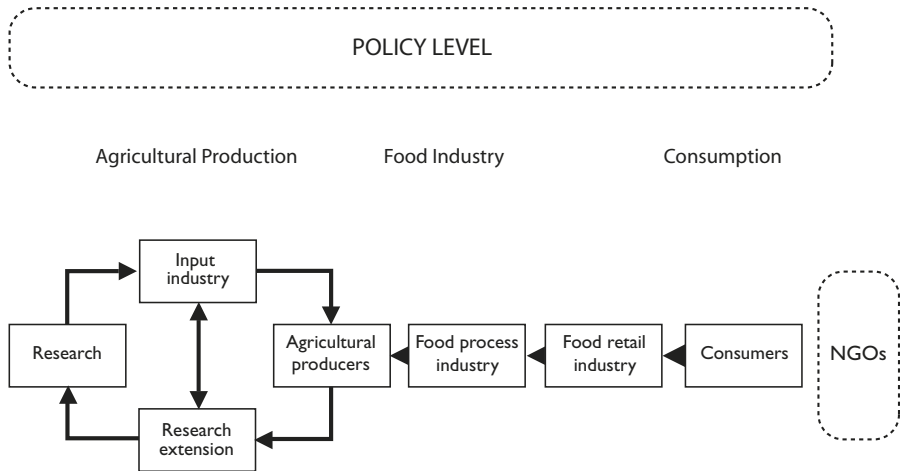
	1970	1980	1990	2000
EU-15				
Agricultural employment, 1000 persons	19,227	14,816	10,842	7,657
Share in total economic employment, %	13.3	9.5	6.4	4.3
Korea				
Agricultural employment, 1000 persons	5,605	5,767	3,555	2,387
Share in total economic employment, %	49.1	37.1	18.1	10.0
United States				
Agricultural employment, 1000 persons	3,842	3,896	3,647	3,024
Share in total economic employment, %	4.3	3.5	2.8	2.1
Australia				
Agricultural employment, 1000 persons	437	434	464	447
Share in total economic employment, %	8.1	6.5	5.5	4.6
New Zealand				
Agricultural employment, 1000 persons	130	148	168	170
Share in total economic employment, %	11.8	11.2	10.4	9.0

Source: FAOSTAT (2005).

employment with adequate incomes (figure 2.4) due to efficient and undistortive agricultural policy.

Reasons for low efficiency of agricultural support in Ukraine

There are many reasons for the low efficiency of farm support in Ukraine, but the overriding one is that the importance of the rules of agrifood chains in the market economy, shown in figure 2.5, is ignored. Farmers are an important part of agrifood chains. In the Soviet time, coordination in the food chain was conducted by central planners in such a way that agricultural producers obtained inputs from prescribed input suppliers and supplied outputs at prescribed prices to certain food processors. The state monitored the fulfillment of plans and the enforcement of contracts. Agricultural producers also benefited from public research and extension. Prices were formed from the bottom up, i.e., farm-gate prices were set to cover production costs plus a guaranteed margin. When production costs grew, farm-gate prices correspondently grew as well. The consumer prices were defined as farm-gate price plus processing and retailer costs. Since consumer prices derived in such way were high, the Soviet government subsidized them.

Figure 2.5: Agricultural producers as a part of food supply chain

Source: Sorby et al. (2003).

Note: Arrows represent the direction of major influences in the supply chain, although influence can flow both ways.

Over the course of transition, the agrifood chains in Ukraine have gone through privatization and restructuring. Today, the price formation has turned from bottom-up to top-down, i.e., consumers determine prices and quality, while farm-gate prices are derived from consumer prices and retailing and processing costs. Consumers send signals to retailers, which are further transmitted to processors. The food processors offer the farmers prices based on consumers' willingness to pay, costs of retailers, their own processing costs, and costs of collecting raw agricultural products. Hence, if the production costs of agricultural producers are lower than the derived farm-gate price, they must either reduce costs or produce other commodities.

As an example, let us consider the dairy and meat markets. Consumer prices of meat and dairy products are defined by domestic consumers and export prices to Russia, Ukraine's major buyer of these products. Food retailers transfer the signals to dairy and meat processors, and these processors purchase raw agricultural commodities to produce the demanded goods. Since small-scale households produce milk and meat in Ukraine, food processors incur large costs of collecting, transporting, and verifying the quality of agricultural products. Often local authorities constrain the movement of milk and meat outside of their regions. These measures keep small food processors surviving, but with high processing costs. As a result, derived farm-gate prices are lower than they could have been with larger-scale farms and consolidated processing plants.

Thus, current agrifood chains in Ukraine urgently need facilitation from the state to ensure the enforcement of private contracts, reduction of transaction costs, provision

of market information, especially to small farmers, and to enable producers to meet the specific quality requirements of modern retailers such as supermarkets. Policymakers should realize that effective supply chains transmit signals to suppliers, who in turn must respond flexibly and efficiently to satisfy consumer demand. They should also realize that on the other end of agrifood chains are input suppliers, who are privatized and do not follow politicians' orders.

So far, Ukrainian policymakers have not recognized the importance of creating favorable conditions for the agrifood chains and accounting for consumer preferences as a precondition of efficient farm development and agricultural support. Instead of establishing the necessary institutions to allow market forces to work and private investments increase, the government interferes directly in the market. The Ministry of Agricultural Policy continues insisting on a Soviet-style price formation approach (production costs plus markup) and supporting low-quality production from inefficient agricultural producers. Moreover, many policy measures increase uncertainty, causing greater price (and marketing margin) fluctuations and weaker vertical coordination. Unfortunately, as Swinnen (2005) notes, "Bad policies are worse than bad weather. Direct government interventions in the supply chain crowd out alternative financing systems or cause defaults." In Ukraine, as everywhere else, food companies and traders are willing to incorporate vertical cooperation defaults due to unforeseen shocks such as the weather but not systematic risks due to government interventions.

Policymakers in Ukraine have neglected to establish market-supporting institutions, invest in rural infrastructure, or reform agricultural research and food safety institutions. In most modern market economies, the institutional environment is often taken for granted. It exists in the background, serving to facilitate the smooth functioning of market transactions and maintenance of a stable investment climate (Hobbs 2005). But in Ukraine, these institutions are a long way from being fully established and operational. By market institutions, we mean the enforcement of contractual agreements, arbitration, low transaction costs and regulatory burdens, protection of property rights, access to market information, and facilitation of third-party verification of grading schemes, quality assurance, and certification systems. Hence, public money must be invested in market institutions, infrastructure, and reformed research institutions and food safety/quality agencies. Otherwise, state support of agricultural producers will remain fully inefficient.

Future policy constraints

To enhance agricultural competitiveness, agricultural policymakers in Ukraine must rethink agricultural support, but within certain constraints. In the future, Ukraine's agricultural policy will be constrained by the membership requirements of the WTO, and probably the EU. Membership in the WTO and EU will bring many economic and political benefits but will also affect policymaking, in most cases for the better for Ukrainian economy (Burakovsky et al. 2004).

WTO membership¹³

WTO members agreed to gradually liberalize agricultural trade by creating a less distortive environment for international trade. The agricultural trade liberalization is encouraged by policy constraints in four areas: market access, domestic support, export subsidies, and technical regulations.

Market access: Ukraine will reduce agricultural import tariffs from 30 percent to 13 percent on average, and there are indications that the WTO working party is more or less in agreement with this proposal. The reduction of import tariffs will seriously threaten only meat products, fruits and vegetables, and sugar, because other agricultural commodities are mainly exportable. Ukraine will set a tariff-rate quota for sugar at close to zero, but keep high (50 percent) import tariffs for out-of-quota imports. After the Doha Round, Ukraine will have to reduce import tariffs further, which will prevent future large increases of minimum sugar prices.

Domestic support: Ukraine will probably secure the bound AMS at US\$1.14 billion or UAH5.7 billion. Based on rough calculations, the current AMS in 2005 will equal UAH2.3 billion or 40 percent of the bound AMS (budget transfers from the “amber box” plus consumer transfers due to sugar quota). If the system of minimum prices for grain and oilseeds takes effect, the current AMS can substantially increase by the amount calculated as quantities sold at minimum prices multiplied by difference between minimum and world reference prices. Although currently WTO commitments on domestic support do not constrain the expansion of “amber box” measures, in the future a probable decrease of world market prices, appreciation of exchange rate, future WTO reduction commitments, and larger agricultural subsidization in Ukraine will require Ukrainian agricultural policymakers to search for more efficient ways of supporting agricultural development.

Export subsidies: Ukraine is committed not to use subsidies to stimulate the export of agrifood products. This is a rule for all new members of the WTO. An important implication of this fact is that as a net exporter of most important agricultural commodities, Ukraine will not be able to employ domestic price support measures. This is because domestic price support in an export situation necessarily leads to the accumulation of surpluses that can be exported only with some form of export subsidy, either explicit or implicit. This means that the system of pledge and minimum prices, if they exceed the world market level, is fundamentally inconsistent with the likely condition of Ukraine’s WTO membership. It also means that since sugar prices in Ukraine are twice the price of the lowest cost suppliers, Ukraine will be able to export sugar only to a limited number of countries where sugar prices are even higher than in Ukraine (e.g., Azerbaijan).

In the area of SPS regulations, Ukraine will benefit from access to the dispute settlement mechanism, but it should take every possible step to ensure that problems

13 See more detailed analysis in von Cramon-Taubadel and Zorya (2004).

with the quality and safety of its food exports do not fuel a demand for excessive SPS standards in other countries. On the import side, Ukraine will be forced to stop using SPS measures as a barrier to trade. According to the WTO Agreement, the SPS measures must be based on a “risk assessment,” and stronger-than-international standards, if used, must be justified by scientific evidence. This is intended to prevent the use of strict regulations that reduce market access but that are not justified by scientific evidence. Finally, Ukraine will have to provide timely notification of changes in SPS regulations to the WTO SPS Committee, while also benefiting from timely information from other WTO members.

European integration¹⁴

Recently, Ukraine has activated its efforts to improve political and economic cooperation with the EU, seriously aiming at joining the EU. The preparations for accession and membership will have important implications for agriculture and agricultural policy.

With the Mac Sharry reform in 1992, the CAP began its long march away from supporting overproduction to a market-oriented, environmentally friendly policy geared to efficient and sustainable farming. The radical overhaul of the CAP in 2003 was just the next logical step toward a policy that supports not just farming, but the long-term livelihood of the rural areas as a whole. Farm support has become increasingly dependent on meeting quality, environmental, and food safety guarantees. The EU has become more open to international trade, and in order to preserve its position in the global marketplace, reforms of sugar and milk quotas, as well as of the remaining market support, will follow to ensure the growth of agricultural exports without subsidies.

If Ukraine is to join the EU, it must demonstrate the desire and ability to adapt its policies, including agricultural policies, to EU standards. While EU agricultural policy is a moving target, the direction of the movement is clear. Ukraine must anticipate this movement and embark now on a convergence course. Only with more market-oriented agricultural policy approaches attuned to rural development, environment, food safety, and quality along the agrifood chains, can policymakers stimulate agricultural development, ensure fair standards of living for rural communities in Ukraine, and remain prepared to join the EU.

Policy options and consequences in Ukraine

To realize Ukraine’s agricultural potential, agricultural policy must become more market-oriented and coherent. Otherwise, in the next decade we will continue talking about potential, but not successful, development.

In the new market environment, the government must become a *coordinator that develops and enforces the rules by which private sector participants interact within the market arena*. The government must provide public goods and establish support-

14 See detailed analysis in Zorya and Nivyevskiy (2005).

ing legal, administrative, and regulatory systems to correct market failures, facilitate efficient operation of the private sector, and protect the disadvantaged. Public good dimensions include contract law and other legal provisions, trade agreements, competition policy, food safety regulations, establishment and enforcement of grades and standards, infrastructure, training, market information services, and overall coordination of public and private sector activities. Without the support of public sector enabling institutions, private sector agroenterprises and markets will remain inadequately developed and inequitable.

The Ministry of Agricultural Policy should take a lead in collaboration with other public agencies and NGOs in developing *the strategy of agricultural development and the vision of the role of state support in agricultural development*. However, it requires a core capacity within the ministry to tap available policy research, contract with outside institutions to fill research gaps, and analyze research output for use in policymaking. Hence, the ministry should improve its analytical capacities by collaborating with technical assistance providers such as USAID, FAO, World Bank, and EU agencies.

If the government continues direct farm support, *the best policy tool is decoupled income support*. All currently applied support measures must be replaced by this visible support tool, which has proved to be the most efficient instrument to increase farm real incomes in OECD countries. Since the decoupled income support is a “green box” measure, it would not only bring Ukraine closer to the course of agricultural reforms in the EU, but also save Ukraine’s state support from highly probable Doha Round decisions on reduction of “amber box” measures.

Before increasing agricultural support, *obvious handicaps must be removed in near future*. The most important handicaps include export taxes, regional barriers to trade, debts on export VAT refunds, and excessive marketing costs partially due to high direct and indirect costs of certification. Moreover, research and professional education systems, as well as food safety agencies, must be reformed. Reforms will reduce the budget burden; support farmers with better technologies, extension services, and human capital; and provide consumers with safer and cheaper foods.

Policymakers must acknowledge that although Ukraine inevitably has to lower import tariffs on agrifood products due to the WTO, *lower import tariffs bring many benefits*. Consumers will be able to purchase larger quantities of foods due to lower prices. Greater competition will accelerate the transition to more dynamic and innovative farming systems that can adapt more easily to changing market signals.

Finally, *agricultural policy in Ukraine must address the small subsistence households* that produce over 60 percent of agricultural products. These subsistence farms will certainly benefit from investments in rural infrastructure and extension services and may increase their production, but they do not have a future in the competitive market environment, especially when anticipating market integration with the EU. The government should learn the lessons of new EU members on how to tackle this issue, and provide investment grants to small households willing to expand. With

stricter safety and quality standards for agricultural products along the agrifood chains, other subsistence farms will never be able to meet these conditions or earn sufficient incomes. In this case, these households should be supported by means of social safety net policy, not agricultural policy.

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Activating the Land Market

Serhiy I. Demyanenko

EXECUTIVE SUMMARY

Developed-country experience shows that a functional agricultural land market is a necessary condition for development of agriculture, increasing its productivity and effectiveness. Agricultural land is an essential part of the broader market mechanism, and its value is formed under the influence of complex economic factors: rate of inflation, bank credit interest rates, prices of agricultural products and inputs, income per hectare that agricultural producers generate, efficiency of the land market, and the possibility of unimpeded transactions in land (buying, selling, or leasing). On the other hand, the value of the land also influences other factors in the economic system. The value of land that functions as an economic resource directly influences the creditworthiness of agricultural enterprises, the allocation of the other main production resources (capital and labor), and, more generally, the level of investment in agriculture. A well-functioning land market is needed to build a productive and competitive agriculture sector.

Ukraine has taken some steps to develop an agricultural land market. Land privatization and leasing is taking place, but the necessary institutional basis for a well-functioning land market still does not exist. These institutional components are

- land cadastre and a monitoring system
- a system of rights on land registration
- the registration of collateral and other bonds linked with property on land
- a system for resolving land conflicts
- a land mortgage system
- freedom to buy and sell agricultural land

The privatization process and the leasing of agricultural land are beset by persistent problems:

- There is a moratorium on land sales until January 1, 2007.
- Constitutional norms and legislative acts regarding registration of individual state deeds conflict with each other. There are also contradictions between acting laws of Ukraine,

presidential decrees, and the statutory acts of the State Committee on Land Resources (SCLR) regulating the issuing of state deeds and registration of rights on land.

- The monopolistic position of the SCLR in the conduct of land surveys and the artificially high, arbitrary fees it sets for such surveys increase landowner costs for the issuance of state deeds. High fees are also set for registration of landownership rights.
- State deeds are issued only to individuals, not to a group of persons, and there are no state deeds on joint partial or joint common rights on land.
- Landowners have insufficient information about existing legislation and their rights and options.
- There is insufficient competition on the land lease market, which leads to unequal market power, a quasi monopsony by the lessee, and low lease price on land.
- Operational expenses connected with land lease transactions are high.
- The rights and obligations of landowners and lessees are imbalanced: lessees have far more rights and opportunities to influence conditions of a land lease than lessors.
- There is no land mortgage system.
- Land has a low market price, the result of all the foregoing problems.

Ukraine lags far behind other countries in Central and Eastern Europe (CEE) land reform and the creation of a competitive market for agricultural land, which is an important precondition for increasing the productivity and competitiveness of agriculture. Quick and effective measures to speed up this process are thus urgently required. Ukrainian authorities need to

- abolish the moratorium on the sale of agricultural land
- abolish the prohibition on foreigners buying agricultural land
- issue state deeds of joint partial or joint common ownership rights on land at the request of landowners
- pass the law “On State Land Cadastre,” and provide for monitoring of the land cadastre
- create one national public registration system of ownership rights on land and ensure the legal union of a land holding and buildings, improvements, and plantings located on it
- provide access to e-information about available lands for sale to all who are interested
- ensure a transparent regime for the conduct of land sale transactions, one that includes an obligatory term of one or more months during which a seller or buyer can rescind the transaction
- provide priority rights for Ukrainian citizens—in particular, farmers and other agricultural producers—to purchase agricultural land
- balance the rights and obligations of lessees and lessors by making corresponding changes in the law “On Land Lease”
- provide all interested persons with access to all information about land leasing, its terms, and lease payments

- abolish payment for state registration of landownership rights for those who received it free of cost during privatization, and set a minimal payment (at the level of actual cost) for state registration of landownership rights
- create a mortgage institution (bank) for issuing mortgage bonds insured with a lien on land and other real estate, and let commercial banks issue mortgages with these bonds

Prompt implementation of these measures will create the necessary conditions for the functioning of the agricultural land market in Ukraine, increasing productivity and effectiveness of agriculture, strengthening the export potential of the country, and improving the wellbeing of its citizens. The longer these measures are delayed, the longer the benefits of these actions will be delayed.

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Goals and functions of an agricultural land market

A basic principle of the market economy is that limited resources—land, capital, and labor—will be used most effectively under conditions that most closely approximate pure competition. This is the ideal under which the highest economic efficiency is achieved. Of course, to reach such an ideal is difficult, but the principle helps to define priorities in building an effective economic strategy.

The market functions effectively under the following conditions:

- There are many sellers (supply) and buyers (demand).
- No one interferes in pricing.
- It is quite easy to enter and leave the market.
- Anyone may participate in the market as a seller or buyer.
- All market participants are equally and fully informed about market conditions.

These conditions must be created by the state to ensure land's effective use and guarantee the rights of buyers and sellers. The more sellers and buyers participate in the land market, the fairer the market price will be and the more opportunities to achieve the best business results. Control of land prices and interference in the pricing system lower economic incentives for sellers and buyers and block effective functioning of the market. Synthetic or arbitrary barriers to market entry and exit by buyers and sellers reduce competition and make the discovery of a fair and balanced price for land impossible.

Among the most important conditions for an efficient land market is that all participants are fully informed about market conditions. They must all know the rules and procedures (laws that regulate land issues) and have equal access to market information—in particular, the conduct of land transactions. Prices and conditions of land sale should be published in the local press and on radio, TV, and the internet. It is also reasonable to legally permit a period of time—one to several months—when a seller and

buyer can think over signed purchase agreements and either can cancel. Adhering to these rules and procedures creates obstacles for dishonest operators and provides rights and protection for all market participants, especially new landowners and millions of poor, rural Ukrainians.

The essential elements of the land market in a market economy were summed up by Lehrman, Csaki, and Feder (2002, 55):

The land policies of transition countries should be evaluated against the basic attributes of market agriculture, namely private landownership, transferability of use rights, security of tenure, and individual or non-collective organization of production.

In a market economy, the main goal of the land market is to provide for the transfer of land from less efficient to more efficient producers or other users, thereby maximizing its value. The role of the agricultural land market is to transform land into capital, which may be used to create an income stream for landowners. Only when private property rights on land as capital are realized can land reach its full potential as an economic resource. And the institutional structure of the land market determines the degree to which land can function as capital. For land to fully function as productive capital, the land market must ensure efficiency, transparency, and the guaranteed exchange of private property rights for land. The instrument that provides for the functioning of land as capital is the land mortgage system, an important element of the agricultural land market. The system operates through specialized and universal banks by providing mortgage bonds or mortgage-backed securities.

A common axiom in the market economy is that land is a valuable part of the economic system; it has market value and is included in the costs of agricultural products through lease rental rates. Reallocation of land use through sale or lease is the process through which land rises to its best use, or greatest productivity. That is why successful agricultural production requires the following conditions:

- private land rights
- land market, including buying, selling, and leasing
- mortgage lending with the collateral of land and other real estate

These three elements are closely linked. For example, mortgage lending using land and real estate as collateral is impossible without the existence of private land rights, and the land market is impossible without mortgage lending with land collateral. All these issues need to be addressed comprehensively to provide for the functioning of each component, as well as general functioning of the land market. That is what land reform in Ukraine was intended to accomplish, but the process has never been completed.

Agricultural land market experiences of other countries

A functioning market for agricultural land consists of two parts: sale of land and leasing of land. The functioning of a land sales market depends on a country's legal regulations. For example, the sale of land in most countries may be conducted on the basis of private agreements, via real estate agencies, or at auction (Hesser 1998, 10–12).

Private agreements are most popular when land is sold by one farmer to another, especially when they are neighbors. A farmer planning to increase his or her farm size by buying neighboring land can wait for the opportunity for many years. Usually, young farmers make purchase agreements with older colleagues who are retiring. An important aspect of these agreements is confidence; the retiring farmer wants to see the land go into reliable hands.

Sellers can also contract with real estate agencies that employ commercial agents who are specialized in the transfer of agricultural lands. The agency lists the land in its properties for sale and negotiates with potential buyers on behalf of the seller. Such buyers may also contact one or several agencies to find the land they desire. Agencies propose options to them for purchasing the land and help arrange conditions of the sale. Usually, people unfamiliar with the local land market become clients of such agencies and are willing to pay a fee for their services.

Auctions can be attractive to farmers retiring from the business, landowners unwilling to continue leasing out, and people inheriting land. Such sellers contact an auctioneer familiar with the local land market and agree to a sale date and, sometimes, to a minimum price. The auctioneer helps to prepare the announcement that is published in the local press for one or two months before the auction. Potential buyers gather on the sale date, the auctioneer announces an initial price on behalf of the seller, and bidding begins. The seller has the right to stop the process. After a bid is received that no other bidders surpass, the auctioneer announces the winner—the person who offered the highest price.

General sources of financing for the purchase of agricultural land in the United States are the owners of the land, insurance companies, commercial banks, and federal land banks. The seller is also an important source of financing. In such cases, the buyer makes a partial payment and is obliged to pay the rest over a time period on the security of the purchased land. If the buyer cannot make the partial payment, the seller may hold the land title until the buyer gets a loan from a credit institution to pay the balance. This constitutes an agreement of the land sale, with deferment of transfer of owner rights until the total is paid.

Life insurance companies often give long-term credits for purchasing farms. The volume of financing usually is 60–75 percent of the value of the sale agreement, to be repaid in 20 years. Commercial banks—mostly those located in agricultural areas—also give loans for buying farms to their most reliable farmer clients. Mostly, these are short-term, 5–10-year loans.

In 1916, the U.S. government created a system that included 12 federal land banks. This system initially received federal government grants, but was reorganized later according to a cooperative principle. Today, federal land banks are oriented to serve farmers who take loans for up to 40 years. Those who have perfect credit records and high-quality business plans may qualify for credit up to 85 percent of the collateral value.

In Germany, loans against land collateral are provided by the Agricultural Lease Bank (founded in 1949 as a successor of the liquidated Rent Credit Foundation (Herrmann 2002). The statutory capital of the new bank was created by annual contributions between 1949 and 1958 from every German agricultural enterprise (including forestry and gardening). The contribution was 0.15 percent of the corresponding fiscal value of land, or so-called interest on land debt to the bank. Due to this kind of self-help by agricultural producers, private lands managed to collect the main capital of the bank (DM264 million) without using German federal government resources. The Agricultural Lease Bank does not give credits to end users. It is a refinancing institution that gives money to banks for them to allocate and direct. Due to this procedure, the administrative expenses and risk level of the banks are very low. The lease bank finances agricultural activities of any type and offers special loans with lower interest rates for agricultural purposes, along with loans at market rates. As an exception, the bank can give loans directly to the borrower, but in large amounts—up to several million euro.

In general, this bank—which exists in legislative form as a public institution and was created in an exceptional way due to self-help of the farmers—is an example of how state functions can be undertaken without using taxpayer funds. The model clearly shows that in conditions of shortage or even in the absence of state money, it is possible to perform tasks linked with supporting agriculture, especially on the basis of self-help.

Despite land sale possibilities and good legislative and institutional structures in countries where agricultural land markets work well, transactions take place very rarely, with about 1–2 percent of land changing ownership annually. This applies to the United States as well as Ukraine's nearby neighbors—such as Poland, Hungary, Czech Republic, Slovakia, and Latvia—that recently completed land reform and land privatization and initiated agricultural land markets (Lehrman, Csaki, and Feder 2002, 67–68).

The functioning of agricultural land markets needs to be evaluated on the basic principles of a market economy. Using these principles, the World Bank conducted research on the land market policies of several countries of Eastern Europe and the former Soviet Union (Lehrman, Csaki, and Feder 2002, 79–84). The evaluation used two criteria: the presence of private agricultural land property and the freedom to sell and lease land. The Bank also assessed the program and strategy of land privatization, the strategy of land allocation, and legislative conditions for the transfer of property rights

on land. In particular, the analysis addressed how a country allocated land as private property to its citizens—whether by restitution, shares allocated to people working on the land, land sale, or lease—legislative conditions for transfer of property rights on land, and whether privatization involved the issuance of land certificates or state deeds. The evaluation assigned coefficients and defined a summary composite land policy index for countries, including Azerbaijan, Albania, Belarus, Bulgaria, Armenia, Georgia, Estonia, Latvia, Lithuania, Kazakhstan, Moldova, Kyrgyzstan, Russia, Tajikistan, Turkmenistan, Czech Republic, Slovakia, Ukraine, Hungary, and Uzbekistan. The highest index—10—was received by Hungary and Romania, and the lowest by Uzbekistan and Belarus—0.6 and 1.3. Ukraine, 15th among 22 countries evaluated, received a composite index of 6.7. This comparison is not positive for Ukraine, and confirms that the country should speed up the creation of a competitive agricultural land market.

Privatization stages for agricultural land in Ukraine

The beginning of the land reform in Ukraine is thought to date from March 15, 1991, when the land code and decree “On Land Reform” came into force and all lands were declared to be subject to land reform.¹ However, only one of three basic conditions of a functioning land market has been achieved in Ukraine during the past 14 years: the transfer of land to private property. According to the Ministry of Agrarian Policy, there were 5.2 million state deeds on agricultural landownership rights in process on June 1, 2005. This represents 76 percent of land certificate owners, though many of them do not yet have a completed title to the land. All other conditions of an effective agricultural land market have yet to be fulfilled.

A moratorium on agricultural land sales in Ukraine is to last until January 1, 2007. Despite this, land transactions continue, especially those involving agricultural lands around cities. It is misleading to claim that land has been privatized when owners are not permitted to freely manage that asset, including the right to sell. That is why the moratorium should be canceled immediately. Moreover, the land code of Ukraine does not permit land to be sold to foreigners.² This limits the right of ownership of agricultural land and its turnover, and diminishes the demand for land and lowers its price. (The inefficiency of agricultural production and insolvency of many domestic agricultural producers also serve to lower demand and prices.) Alternative means of bypassing the legislation include the assignment of land to a statutory fund, using an exchange agreement and long-term lease with a right to buy, and the use of straw men. These limit the normal functioning of the land market and diminish land prices.

Privatization of agricultural land in Ukraine was induced by the need to transfer land to those who had worked on it. The privatization of land meant for agricultural use was implemented in two ways. First, the state started transferring agricultural

1 “On Land Reform” was adopted by Ukraine’s Verkhovna Rada (parliament) on December 18, 1990.

2 See “On Transition Regulations,” Article 22, Issue 10, pp. 4, 13, 14, and 15.

land from the state land reserve to individual citizens as private property for farm and peasant use. Second, the state initiated complex measures to grant landowner status to members of agricultural enterprises for land they were using.³

When state monopolistic ownership of land in Ukraine was cancelled, almost all utilized agricultural lands were being used by collective agricultural enterprises (CAEs) that were mostly created from transformed traditional Soviet agricultural enterprises (collective and state farms). That is why privatization of agricultural lands in the use of agricultural enterprises became a main goal of land reform in Ukraine. From this goal emerged the idea of organizing agriculture so that the advantages of large-scale agricultural production in large land areas could be combined with advantages that flow from giving to a peasant the status of landowner and transferring to him or her the means of production.

During Ukraine's first stage of land reform, there was an attempt to realize the goal by transferring land into collective property. That is why the Verkhovna Rada (parliament) of Ukraine ratified a new version of the land code on March 13, 1992, one that introduced collective ownership of land and started the first stage of land reform. The main task during this stage was the transfer of land, and agricultural land (except some land left in a state land reserve) was transferred from state ownership into the collective property of CAEs. In January 1993, 99.5 percent of CAEs received land as collective property. That meant that 27.6 million hectares of agricultural land—45.7 percent of the land fund of Ukraine—were transferred from state into collective property.

But the transfer of the land into the collective property of CAEs did not make its members real landowners. For that reason, there was an attempt to strengthen the legal status of CAE members as co-owners of collective property on November 10, 1994, when land reform began to move in the direction of distributing the agricultural land collective property of CAEs.⁴ Each CAE member was given an allotment (share) of land, which was identified with a certificate. Owners of these allotments received the right to manage them and, specifically, to get them in the form of land. The right of private ownership was also identified by state deeds. More than 6 million citizens—members of about 11,000 CAEs—received certificates that gave them the right of ownership to an allotment of land.

But distribution of the collective property of lands did not achieve the main goal of land reform: to turn CAE members into working owners, masters of their lands and the enterprise's equipment. The members continued to be only a hired labor force, even after distribution of the land and equipment. Further, land and equipment were distributed very slowly, and often only as a formality. In many cases, certificates on the right of ownership were not given to peasants, but kept in the safes of CAE chiefs. Collective

3 In Lviv Oblast, privatization of agricultural land had its own peculiarities. One was that land of the collective farm was not transferred into common property, but straightaway shared among its members. In villages, social and cultural workers also received agricultural land shares. In other regions, only agricultural workers received such land shares.

4 This came with the presidential decree "On Urgent Measures Regarding Speeding Up of the Land Reform in the Sphere of Agricultural Production."

property—the equipment and land of CAEs—was viewed as property of the enterprise, not of its members.

With ratification of Ukraine's new Constitution on June 28, 1996, collective property was abolished as a separate kind of property. But, in practice, the status of a CAE as a *de facto* “collective property” owner of equipment and land barely changed. In fact, CAEs acted as competitors to enterprise members, who were formally the co-owners of shared land and equipment. This caused measures to be taken to deepen land reform in Ukraine. In particular, on January 10, 1997, in Kiev, the All-Ukrainian Council on the Questions of the Agricultural Sector accepted a new strategy for land reform based on transforming CAEs into a new type of market institution operating on the basis of land and equipment as private property of individual members. In particular, the council's recommendations defined the content of Ukraine's third stage of land reform, beginning in 1997.

To provide for the transfer of the land and equipment into the private property of their members, CAEs had to be restructured. Market-oriented agricultural units had to be created: private enterprises, associations with limited liability, joint-stock companies, and private farms. Acceptance of the 1997 strategy on land reform was confirmed by the All-Ukrainian Council of Peasants on February 9, 1999. But the process of land privatization and CAE restructuring remained in permanent stagnation. At the end of 1999, less than 10 percent of CAEs were reformed and even fewer had completed land surveys and provided peasants with state deeds on landownership. International technical assistance projects—in particular the USAID Agricultural Land Share Project—played an essential part in the reform of CAEs and the issuing of state deeds to land certificate owners. But a radical shock was needed to speed up the process: the presidential decree of December 3, 1999, turned out to be a critical moment in privatization of agrarian land and restructuring of CAEs.⁵

On March 24, 2000, the Ministry of Agrarian Policy reported 11,169 new agricultural entity formations that made up 99.7 percent of CAEs. Within these registered enterprises there were 711 (6.3 percent) private family farms, 2,444 (22.9 percent) private enterprises, 5,020 (44.9 percent) agricultural associations (mostly associations with limited liability), and 2,762 (24.7 percent) agricultural production cooperatives (Shmidt 2000, 31–34).

Functioning of the agricultural land market

Agricultural land lease market

The existing state of agrarian reform and the formation of a land market in Ukraine can be explained by unresolved contradictions between competing goals. One goal is the creation of a competitive agrarian sector. The other is the need to provide social

5 This presidential decree was “On Urgent Measures for Speeding Up Reformation of the Agricultural Sector of the Economy.”

support for ex-members of the reformed collective agricultural enterprises and other villagers who, in general, are the owners of agricultural lands. Politicians are afraid that landowners will be swindled when a land market is introduced. Peasants are afraid too—not so much of the market as of the problems they may face as landowners. Their fears stem from poor information available to them. The owners of certificates are afraid that they will lose subsidies for gas and electricity and have to pay high land taxes when they receive state deeds and become landowners. But this problem can be solved only by developing an agricultural land market, not prohibiting it. The solution is to set transparent and clear rules concerning transfer of land holdings and provide full, widely disseminated information about these transfers.

In the land market process, land use is transferred from lower-value uses to higher-value ones. This may not necessarily mean a direct change of landowner, but it includes the possibility of land being leased by another agricultural producer. Leasing is an essential part of the land market. More attention should be paid to leasing, since the common belief in the Ukraine is that the land market is only about the sale of land. Experiences in other countries show that sale is not the main element of the land market. According to Lehrman, Csaki, and Feder (2002, 64–66), transparency and security of the land lease transactions are even more important than legal property rights in fostering agrarian production.

A significant portion of agricultural producers in developed economies are lessees, rather than landowners. In particular, more than 60 percent of agricultural lands in Belgium, France, and Germany are leased. Leased land is 40 percent of the total in EU-15 countries and 30 percent of the total in Canada. In the United States, purely owner-operated farms account for only one-third of the country's cultivated land, while 55 percent is mixed owned and leased farmland and 10 percent is all leased.

Farm size also affects the productiveness and effectiveness of agriculture. It is possible to increase the size of agricultural enterprises in countries where the land market functions effectively and there are clear and transparent rules of land transfer and leasing. The average size of the enterprise of an EU farmer who leases more than 30 percent of cultivated land is 40 hectares, while the enterprise of farmers leasing less than 30 percent average only 18 hectares. The same tendency occurs in other countries (Lehrman, Csaki, and Feder 2002, 66). In Ukraine, by contrast, some enterprises lease tens and hundreds of thousands of hectares. This is not a normal phenomenon, and probably is not good for agricultural land market development.

Today, the only indicator of the market price of agricultural land in Ukraine is the level of payment by lessees to lessors. In 2004, the average lease payment for 1 hectare of agricultural land was about UAH120. If inflation were 12 percent and the bank's interest 18 percent (in the absence of mortgage and long-term credit), then the value of 1 hectare by the simplest calculation is UAH2,000 ($120 / (0.18 - 0.12)$). Of course, one should not oversimplify from average data. For example, in the Odessa region, where vegetables are grown and soils are very productive, some farmers pay

UAH1,000 per hectare. Using the same procedure, land in the region would cost about UAH17,000 per hectare. If the land market were operating normally and mortgage lending were available at about 7 percent with an inflation rate of 2 percent, the land cost would be about UAH20,000 per hectare or about US\$4,000, comparable to the cost in developed countries.

The level of the lease payment is affected by a series of factors: inflation; prices of agricultural products and inputs; salaries of agricultural workers; the level of state support for agricultural producers; the level of financial market infrastructure development (including bank and financial services such as long-term and mortgage credit, commodity exchange, leasing, and insurance); operational expenses for the lease contract registration; and how many people wish to lease land. The last factor is determined by the presence of agricultural producers in the country and whether foreigners can lease land. Research shows that competition in the land market could increase lease payments by an average of about 50 percent for all regions of Ukraine, which is 2.5 times its minimal level (Kuhn and Demyanenko 2004, 81–88). Among all agricultural enterprises, the maximum and minimum lease rates already differ by a factor of 10.

The lease rate and, correspondingly, land prices are also influenced by expenses associated with the registration of lease agreements, the lease land search, agreements on the term, lease payments, and the cost of drawing up the contract and notary services. Thus, the level of these expenses depends on the registration fees assessed by the government; the functionality of the land lease market; the development of market infrastructure—in particular, the availability of information about land lease areas; and the existence of a network of notary offices and the cost of their services.

The less developed the lease market, the higher operational expenses will be for the drawing up of lease contracts, and lease payments will be correspondingly lower. The low levels of lease payments for agricultural land in Ukraine—roughly 15–20 times lower than in EU countries—is understandable, given the instability of Ukrainian registration procedures, the absence of long-term credit, high interest rates for short-term credits, and the lack of yield insurance, normally functioning spot markets, and futures exchanges for agricultural products. All of these are linked to risks that affect leasing relations, bringing lower incomes for a landowner. Consequently, the price of land in Ukraine is 18–20 times lower than countries with well-functioning land markets.

In a well-functioning land market, the two main subjects of rental relations are the lessor and the lessee. The lessor has the following alternatives: continuing the lease contract with the same lessee; finding another lessee; operating the land himself or herself (requiring mortgage lending that uses the land as collateral); or selling the land. Each alternative entails different levels of operational expenses, which are directly linked to the land market functionality.

Because individual land plots in Ukraine are located inside larger fields and selling them or passing them to another lessee can be problematic, the cheapest alternative for the lessor is to continue the lease contract with an existing lessee. Besides, land plots are small, averaging 2–12 hectares. Ukraine therefore has an inefficient and “thin” land lease market, with an imbalance of market power. This is also one of the reasons for low lease payments and, correspondingly, low value of land. The country has about 7 million individual owners of agricultural land and only about 60,000 agricultural enterprises. About 10,000 of these are large agricultural enterprises (former collective and state farms) with an average size of 1,850 hectares, and 43,000 are farmer’s enterprises with an average size of about 80 hectares. In France, which has a similar amount of agricultural land, there are 590,000 farmer’s enterprises—10 times more than all agricultural enterprises in Ukraine.

To reduce the excessive market power—a quasi monopsony at the local level—of the largest enterprises and solve the inefficient land lease market problem, a legislative mechanism is needed for uniting land plots into separate land tracts and managing them in accordance with landowner group’s interests. The legislative basis for this already exists. Article 86 of the land code of Ukraine requires the existence of joint partial property on land, with or without definition, of every landowner’s part (joint common property). The right of joint property ownership of land should be certified with the state deed of landownership. Besides this, the possibility of land plot transfers between landowners is needed to promote effective land use and lower the operating expenses of managing land. Such transfers must be permitted at little or no cost to landowners.

The important question of whether landowners and rural communities organize themselves to defend their property interests and social rights will depend on the strengthening of civil society in Ukraine and the organization of a functioning agricultural land market. In addition, an important factor for overcoming the market power of large enterprises in the land lease market is an increase in the number of potential lessees—especially middle-sized farms—in the market.

“On Land Lease,” the current law of Ukraine, does not favor the development of the land lease market (Kulynych 2004, 31–38). The law overly regulates rental issues and creates an imbalance of rights between landowners and lessees. In particular, the law requires all of the following papers in a land lease contract (the absence of any one annuls the contract):

- a plan or scheme of the land plot to be transferred for lease
- a cadastre plan of the land plot with designation of limits to its use and set land servitudes
- a statement of demarcation of land in a field
- a deed of conveyance of the leased object
- a draft of land plot allocations in cases required by this law

In the law, the order of defining terms for the lease of agricultural land is in accordance with the main crop rotation and the organization of land use. This means that lease contracts are drawn up on the same terms as existing crop rotations that can cover 6–10 fields. This violates the rights of landowners for free land lease contract terms. After issuing state deeds, the law also requires that the lease contract be renewed on the same conditions, with the agreement of both sides. That means that when the land certificate is exchanged for the state deed, the existing lease contract is automatically prolonged on the same conditions and for the same term.

There are also several problems that relate to registration of agricultural land lease contracts. Though Ukraine has no legislative rules for such registration, “On Land Lease” mandates registration of agricultural land lease contracts, which lose their force if they are not registered. Though the December 25, 1998, decree of the Cabinet of Ministers of Ukraine stated that state registration of lease contracts was within the jurisdiction of executive committees of village and city radas, land lease contracts on behalf of the state are registered by an office of the Center for State Land Cadastre (CSLC), which were created by the SCLR. This is illegal.

There are other regulations of “On Land Lease” that increase the imbalance of the rights of landowner and lessee:

- Lessees have a privileged right to purchase leased land as their own property (Article 9) and to renew a land lease contract after its expiration date (Article 33). This article states that if the lessee continues to use the land, and the landowner does not provide a written prohibition within a month after the expiration, the contract is renewed with the same term and conditions.
- Article 24 states that the landowner is obliged to reimburse the lessee for capital outlays linked with improvement of the leased object that were effected with the agreement of the landowner. Landowners who cannot reimburse the expenses may lose the land through expropriation via court decision. The law does not require landowners to be informed about the value of such outlays or to give written permission for such investments.

As a rule, land is leased by agricultural enterprises that resulted from the reorganization of collective enterprises, farms, newly created agrarian enterprises, or branches of other nonagricultural companies (Ministry of Agrarian Policy 2005). The lessee is in a much better position than the lessor, and can exploit the existing situation in land lease markets. These markets are characterized by nonmobility of land plots: one plot cannot be united with another and transferred to another lessee. Lessees usually lease huge areas of land—sometimes all lands of a village or several villages—and their operational expenses on one land lease contract will be much lower than those of a small lessee. Using their unequal market power, these lessees can lower the lease payment, because landowners have little or no alternative to making a land lease contract with them. After the contract term expires, the lessee

may continue the contract, discontinue it, or change it to be more beneficial to himself or herself.

But lessees face other general problems in the agricultural land lease market. In particular, small farms find it difficult to compete with large agrarian companies, and especially with agroholding companies. These companies appeared in Ukraine as a result of the undeveloped land lease market, low lease payments, and tax privileges in agriculture, and they each lease tens of thousands (or sometimes hundreds of thousands) of hectares. This further increases the unequal market power that characterizes the land lease market in Ukraine. These lessees complain about the short terms of land lease (one to five years) and insist they should be longer (Ministry of Agrarian Policy 2005).

The imbalance of demand and supply in Ukraine's agricultural lands lease market contributes to the market being characterized as inefficient or "thin." It constitutes a quasi monopsony at the local level, with the following consequences:

- Agricultural land is very rarely transferred from one lessee to another.
- Landowners are not organized to defend their rights and economic interests.
- There is no legislative mechanism for uniting land plots to resist market power in the land lease market.
- Operational expenses of land lease registration are relatively high.
- Conditions promote the creation of agroholdings that each lease tens or hundreds of thousands of hectares.
- New individual farms and middle-sized agricultural enterprises are not being created.
- Lease payments for land are quite low.
- The level of competition in the land lease market directly affects the level of lease payment.
- The calculated potential value of agricultural land is very low.
- Agricultural land leases cannot be used as collateral for long-term or mortgage credit.
- In the leasing process, landowners lose control of how their land is used and its productivity level.

These consequences suggest the following causal chain. The structure of land property creates unequal conditions between land lease market participants. This leads to inefficiencies that demonstrate the weakness of the market and lowers the level of land lease payments. In the end, this causes low prices for land—the reason for shortage of credits—because the land has low collateral value. This will create problems for those large agricultural enterprises that seemingly now profit from low lease payments. However, in the long-term, the quantity of landowners will decrease, as the land market's normal operation leads to its concentration in the hands of more

effective managers. This will lower operational expenses and increase the market value of land.

Ownership and sale of agricultural land

There were three stages in the process of agricultural land privatization: denationalization, when agricultural land was transferred from state property into collective enterprises and certified with state deeds; allocation, when assets of collective agricultural enterprises and their land were distributed among their members and land certificates were issued that indicated the size of the land in hectares; and transfer, when state deeds acknowledged the land as private property and designated fields and demarcations.

In contrast to the other components of agrarian reform, the privatization process in Ukraine followed a clear, logical scheme and corresponding legislative provisions (law of Ukraine, presidential decrees, regulations of the Cabinet of Ministers of Ukraine, and departmental acts of the SCLR). But implementing a process as difficult as land reform presents complex challenges. Finishing the privatization process and providing for a normal land market requires the institutional basis of the land market in Ukraine to be worked out, including defining the institutional basis for land sale and ownership rights, along with cadastre monitoring, planning of land resource use in the context of corresponding legislation, registration of landownership rights, registration of collateral and other obligations connected to ownership of land, conflict resolution, and land mortgages.

A cadastre and a register of land plots are two important land market documents. The cadastre, made with the help of geographical informational systems (GIS), describes the physical characteristics of land plots. The register of land plots describes their legal state and indicates past and present landowners. Such registers also indicate other rights or easements, such as the right of a third party to use a road on leased land. Information placed in one system can be seen in the other. For example, a plot's owner may be mentioned in the cadastre, but the register remains a document that describes the legal status of the plot. The register may include map copies and describable parts of the cadastre. But just the register, not the cadastre, confirms the right of ownership and other rights to land. The institutional context of these two elements may have different forms, depending on traditions and the importance of some constitutional and legal principles. But the institutional context of the land market is not only a legislative matter; it also has important economic consequences for village development.

The goal of land privatization is to give millions of people the right to own land as capital. As such, land can be used for creation of additional capital for future landowners. It can be granted for lease, for use as a production resource in agribusiness, as a location for a building (if allowed by current legislation), or as collateral for a loan. Only when landowners can realize their right of ownership is the capital they own func-

tional. The institutional structure of the land market defines the extent that land can function as capital.

First of all, the effectiveness and transparency of ownership rights transfer need to be ensured. In many developing countries, owners of capital suffer a very high level of bureaucratic red tape. Opening a new business, applying for credit, or selling a property may involve bribing many state officials, and may take half a year's salary and demand a lot of time. Because of such concerns, many contracts for land market transactions are informal gentlemen's agreements and are not formally drawn up. This type of transaction should be avoided in Ukraine. The number of land contracts is likely to be very high when the moratorium on land sales is canceled, and land market transaction procedures should be simplified to the maximum extent possible. Responsibility for solving land questions should not be divided between numerous state structures and administrative levels, as this increases the time and cost of transactions.

The next important issue is guaranteed and reliable ownership rights. If landowners cannot quickly and reliably prove ownership rights on their holdings, it will be difficult for them to sell or lease. The absence of a guaranteed right of ownership causes higher operational expenses in the form of a risk premium when negotiating land contracts, which leads to lower land prices. Ukrainian politicians set the moratorium on land sales because they were concerned about low land prices. Insufficient monitoring and unequal balance of power between constitutional branches lead to the absence of guaranteed land rights—especially in Ukraine, where the executive branch has traditionally been strong. If the state is simultaneously a broker and a landowner, the conflict of interest contributes to unreliability of ownership rights, unless there is also judicial control.

One view is that the system may be most effective when one organization monitors and administers land issues. Another view is that the right of ownership is more reliably provided with checks and balances between several constitutional authorities. The compromise may be that control and involvement of all constitutional authorities are not required, but only checks and balances. Ensuring the citizens' rights to appeal administrative decisions in court on a fair basis is an effective way to control abuse of power.

Institutional responsibility for these two aspects of land market regulation (land cadastre and ownership registration) can be shared in several ways (Demyanenko, Schumann, and Kuhn 2003). In Sweden and the Netherlands, the two functions are executed by one state structure. For example, Swedish land surveyors are quite influential, and execute several tasks connected with land questions. This is because land inheritance practices caused land holdings to become so fragmented that the state had to implement measures that would favor agriculture sector development. The land surveyor thus deals with cadastre questions as well as landownership registrations.

In Germany and Austria, the land cadastre is under executive authority and the landownership register under local judicial authorities. This is based on the idea of the

balance of power and the notion that the state, a powerful landowner with executive power, has its own interest in land issues and should not be responsible for the registration of ownership rights.⁶ Both approaches have advantages and disadvantages. The Swedish system is more oriented to state interests, while the German system aims at protection of individual owners' rights. The Swedish system is considered more effective, while the German system is considered to be difficult, slow, and expensive.

After the new land code was ratified by Ukraine's Verkhovna Rada at the end of 2001, the Ministry of Justice and the SCLR both sought responsibility for registering landownership rights. The president of Ukraine solved this question by his decree of February 17, 2003,⁷ which obliged the SCLR to implement this procedure.

Creation of a unique system of landownership rights registration probably could reduce bureaucratic problems associated with a decentralized approach and speed up the process of land registration. This is the main idea of the land and other immovable property registration system, which is to be created by the SCLR with the support of the World Bank's Rural Land Titling & Cadastre Development Project (RLTCD).⁸ The new system foresees a central registration authority being established, based on the existing structure of the SCLR.⁹ The CSLC will be a separate, independent organ that deals only with registration of land and other immovable property; it would not perform land survey works on a fee basis. The positive aspects of this approach are the following:

- The system of registration could use the existing structure of the SCLR, which has wide experience with land questions.
- The SCLR has a strong partner in RLTCD, which will provide substantial support for working out the land cadastre and procedures connected with registration of property rights in land and other immovable property.

On the other hand, the centralized approach gives rise to wide-ranging criticism:

- The SCLR stands accused of trying to become a monopolist in the sphere of land market regulations and having decided to charge fees for its services without waiting for parliament's decision.
- Cadastre and registration functions would be combined if registration of landownership rights and connected operations were performed by the CSLC, under SCLR supervision.

6 Another argument is that the interference of the executive branch is not necessary because most land contracts are between private persons.

7 This presidential decree is "On Measures Regarding the Unique System of Registration of Land Plots, Real Estate, and Rights on It in Compliance with the State Land Cadastre."

8 RLTCD planned to start the issuance of state deeds in January 2004, but this has not yet begun. The project's financing will amount to US\$195 million.

9 On the regional level, there are four main organizations under the control of the SCLR: Main Regional Administration of Land Resources, the CSLC, Oblast Institute of Land Survey, and State Oblast Inspection of Land Use and Preservation.

- The CSLC would be created as a profit making company, since, by statute, its entrepreneurial structure allows it to make money in any kind of activity.¹⁰
- Land market contracts would be controlled only by an organ of the executive branch of government, with no crosschecking by the judicial branch.

Not all these criticism are reasonable, especially the one concerning monopoly power. It is the state's task to register state deeds on the right of landownership. If private persons were to control this right, the result would be chaos in the land market. Though private structures (such as brokers and notary offices) can provide land market services, final confirmation and control of agreements should remain in the hands of a state institution.

The danger for the land market is not so much the monopolistic position of the SCLR as the imbalance or asymmetry of power. The committee should avoid acting outside of current legislation and judicial control—or even giving the impression of doing so. A possible way of achieving procedural effectiveness and avoiding a conflict of interest may be granting the CSLC independence from the orders of the SCLR, even if the registrar of deeds is an essential part of the SCLR structure. One way to ensure independence of the state registrar of land and immovable property would be for the incumbent to be elected by residents of the corresponding registration district. At least, such a system of providing independence of the registrar from the influence of executive power works quite effectively in the United States. But some jurisdictional problems remain, and these have to be solved by the SCLR before it begins its work on the registration of landownership rights.

One can applaud the Ukraine government's decision to avoid creating numerous organizations to deal with registration of landownership rights and concentrate the procedure in the SCLR. Even so, the decision needs to be balanced by involving the local apparatus of the Ministry of Justice and providing judicial authority to strengthen the new institutional structure and guarantee rights of ownership. Some jurisdictional problems need to be solved before the SCLR starts its activities.

Though the new land code was ratified on October 25, 2001, and has been in effect since January 1, 2002, some juridical problems remain in issuing of state deeds on the right of landownership and the registration of land plots. Some official documents regarding contract regulations in the land market contradict each other: those ratified by the Verkhovna Rada and the president of Ukraine on one hand, and documents from the SCLR on the other. Indeed, there are three levels of juridical problems related to maintenance of the state land cadastre and the system of registration of landownership rights:

1. Contradictions between juridical acts and the draft law “On State Land Cadastre”: Article 204, Land Code of Ukraine, and the presidential decree of

10 RLTCDC requires the CSLC's commercial activity to be terminated within three years of the start of cadastre maintenance and registration of state deeds on landownership.

February 17, 2003, require that the SCLR implement the state land cadastre (Kulynych 2003). But the draft law “On State Land Cadastre,” prepared by the Agrarian Policy and Land Issues Committee of the Verkhovna Rada, proposes participation in these tasks by three levels of government (central, regional, local), as well as by the SCLR. These competing norms of legislation constitute alternative approaches to regulation of the land market.

2. **Conflict between constitutional norms and legislative acts relating to registration of state deeds on the right of landownership:** Article 6 of the Constitution required separation of legislative, executive and judicial powers, but Article 75 defines the Verkhovna Rada as the only legislative apparatus of the state. In addition, Articles 14.2 and 92.7 require land property issues to be regulated only by law. That is why the president’s authority to define actions of the SCLR regarding implementation of the state deeds registration system for land ownership rights is debatable. Instead, this authority is being defined by Article 6.2 of the draft law “On State Registration of the Rights on Immovable Property and Its Limitations,” which was prepared by the Verkhovna Rada Committee on questions relating to economic policy, managing the national economy, property, and investments. But Articles 93.2 and 94.2 of the Constitution refer to legislative and executive aspects of the president’s power. If the draft law comes into force, a decision of the Constitutional Court of Ukraine will need to determine the ability of the president to define powers of the SCLR on implementation of registration of landownership rights.
3. **Contradictions between laws of Ukraine, presidential decrees, and SCLR regulations:** On May 23, 2003, the SCLR issued an order that came into force July 3 to implement state registration of land plots, land ownership rights, and the transfer of ownership rights, granting services to physical and juridical persons in the sphere of the state land cadastre data use on a fee basis.¹¹ But the SCLR issued another decree July 2 to implement state registration of land ownership rights, permanent land use rights, and land leases. These registration functions are to be carried out by units of the CSLC.¹²

However, “On Local Self-Governing in Ukraine,” dated May 21, 1997, is still in effect, and it requires local self-governing bodies (villages and towns) to be responsible for the registration of ownership rights on land. Further, the February 17, 2003, presidential decree contains no details regarding registration procedures for ownership rights on land and other immovable property. Instead, it instructs the SCLR to take measures to create the organizational infrastructure for registering ownership rights on real estate to bring the corresponding law into force as soon as possible. In addition, the decree obliged the Cabinet of Ministers of Ukraine to compile, within one month,

11 This May 2003 order was “On Creation of a Unified System of State Registration of Land Holdings, Immovable Property, and Rights on It in Compliance with the State Land Cadastre and Improvement of the Structure of the State Enterprise Center for State Land Cadastre at the State Committee on Land Resources of Ukraine.”

12 This decree was “On Establishing of Temporary Order of Implementing the State Lands Register.”

a list of additional paid services and uses for state land cadastre data provided by the SCLC for agricultural landowners.¹³

Some debates continue between the SCLC and the Ministry of Justice regarding the implementation of the register of land ownership and immoveable property rights. Though the Ministry of Justice was required by presidential decree to implement state registrations of real estate rights and their limitations,¹⁴ another presidential decree, dated May 23, 2005, canceled the previous decision.¹⁵ The execution of the function remains with the SCLC, which charges excessive fees for registration of landownership rights and land surveys and does not follow the requirements of the law of Ukraine (Kulynych 2005).¹⁶

Decrees of the SCLC have pretensions of creating a legislative basis for implementation of the state land cadastre and land registration system. But, according to the Constitution, such laws can be issued only by the Verkhovna Rada (Articles 14, 75, 92.7), the president (Article 106.31), or the Cabinet of Ministers (Article 117). SCLR orders thus contradict the Constitution, as the SCLR has no power to issue official documents. Laws are ratified by the Verkhovna Rada, and executive decrees confirmed by the president or Cabinet of Ministers. Registration of land holdings, an important prerequisite for creation of landownership rights, should be confirmed by law.

Mortgage lending using agricultural land as collateral

An important element of the agricultural land market is mortgage lending, using land as collateral. In developed countries, mortgages are the main precondition for the functioning of medium- and long-term credit markets. Thus, for example, the volume of bonds secured with mortgages in the United States reached US\$3.5 trillion in 1999. In Germany at the end of 2001, the total volume of German mortgage bonds (*Pfandbriefe*) was more than €1.1 trillion. In Ukraine, the volume of all mortgage lending was only UAH1.5 billion at the end of 2002, or 0.7 percent of GDP. This figure is 20 percent in developing countries and 50–70 percent in developed countries (Giucci and Eremenko 2003). Mortgage lending mostly relies on specialized mortgage credit institutions whose main function is refinancing via mortgage securities. Universal credit establishments can also provide mortgage credit, on the condition that mortgage transactions are separated from other financial transactions with a so-called security wall.

The development of a mortgage system in Ukraine requires the appropriate economic, legislative, and institutional preconditions. The economic preconditions

13 The new system for the registration of state deeds requires some payment from persons registering them. The president ordered the Cabinet of Ministers of Ukraine to make a list of additional land use services that the SCLR could perform in return for such payments.

14 This is stated in Article 3.6 of the presidential decree of April 20, 2005, "On Questions of the Ministry of Justice of Ukraine."

15 The May 23 decree was "On Introducing Changes in Some Decrees of the President of Ukraine."

16 See "On Setting Payment Limits for the Implementation of Land Surveyor's Works," January 20, 2005.

are stability of prices and national currency exchange rates, reasonable value of loaned capital, and general economic growth. Legislative preconditions are legislative guarantees regarding private ownership rights for real estate; legislation for the union of a real estate holding and the buildings, improvements, and plantings located on it; legislative security for the mortgage; and legislative regulation of the organization and operation of a mortgage bank. The institutional preconditions are closely connected with these economic and legal prerequisites. They include creation of the necessary banking system; availability of cadastre's services and organization of state registration of real estate rights; availability of notary services, evaluation, and insurance activities; and presence of a securities stock market.

The law "On Mortgage," ratified by the Verkhovna Rada in June 2003, defines the main terms, sets requirements for the object of mortgage and its insurance, defines obligatory parts of a mortgage contract, and clarifies rules of the real estate sale. The law defines a mortgage as a security, which confirms rights on the object of mortgage lending. Beginning in 2005, the mortgaging of agricultural land is also regulated by this law. In general, "On Mortgage" provides important preconditions for a mortgage financing market, but is unfinished. For example, a regulation regarding mortgage bonds is absent.

The capital market should become a crucial source of refinancing of mortgage credit in Ukraine. To make this happen, mortgage credit should be transformed into bonds, which then could be sold to investors on secondary capital markets. There are two main systems for such a transformation of mortgage credits: a system of mortgage bonds and a system of securities that are insured with a mortgage. The latter system functions in the United States and some EU countries. It requires the participation of a specialized institution that buys mortgage credits from banks, transforms them into bonds insured with mortgages, and passes them to investors. In this system of mortgage crediting, participants are a specialized credit institution (a mortgage bank), commercial banks, investors, and borrowers. The system of mortgage bonds used in Germany and many other European countries has three participants: borrowers, creditors, and investors. Creditors grant mortgage credits to the borrowers, and these credits are transformed into mortgage bonds, which are sold to investors.

We support the idea proposed by some experts that it is not reasonable to create specialized mortgage banks in Ukraine (Giucci and Eremenko 2003). Rather than wasting time and money on establishing a network of specialized mortgage banks, it would be better to increase the access of existing banks to financial resources and decrease their bankruptcy risk by diversifying their activities into agricultural land mortgages. It is enough to have a specialized mortgage institution (a bank) that works with commercial banks and issues bonds insured with mortgages.

Plots of privatized land in Ukraine average 4.5 hectares, and about 93 percent of them are not the property of the founders of agricultural enterprises (Ministry of

Agrarian Policy 2005). It follows that about 93 percent of agricultural land is less likely to be used for a mortgage and only 7 percent is more likely to be mortgaged. Nevertheless, caution is required; not all founders of an enterprise may agree to mortgage their land and risk losing it.

Conclusions and recommendations

In Ukraine, the necessary conditions for a well-functioning agricultural land market have not been created. This limits investment, the development and productivity of the agricultural sector, and the wellbeing of Ukraine's people. That is why Ukraine's executive and legislative authorities should urgently prepare all necessary acts and organizational measures for establishing a well-functioning land market. The authorities need to

- abolish the moratorium on the sale of agricultural land
- abolish the prohibition on foreigners buying agricultural land
- issue state deeds of joint partial or joint common ownership rights on land at the request of landowners
- pass the law "On State Land Cadastre" and provide for monitoring of the land cadastre
- create one national public registration system of ownership rights on land and ensure the legal union of a land holding and buildings, improvements, and plantings located on it
- provide access to e-information about available lands for sale to all who are interested
- ensure a transparent regime for the conduct of land sale transactions, one that includes an obligatory term of one or more months when a seller or buyer can rescind the transaction
- provide priority rights for Ukrainian citizens—in particular, farmers and other agricultural producers—to purchase agricultural land
- balance the rights and obligations of lessees and lessors by making corresponding changes in the law "On Land Lease"
- provide all interested persons with access to all information about land leasing, its terms, and lease payments
- abolish payment for state registration of landownership rights for those who received it free of cost during privatization, and set a minimal payment (at the level of actual cost) for state registration of landownership rights
- create a mortgage institution (bank) for issuing mortgage bonds insured with liens on land and other real estate, and let commercial banks issue mortgages with these bonds

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Stimulating Rural Development

Thomas G. Johnson

EXECUTIVE SUMMARY

Agricultural policy and rural development policy should be complementary, but they are nonetheless different. Rural development policy must help rural Ukrainians transform their economy into one that is globally competitive and sustainable. In order to do so, five specific goals for rural development policy must be achieved:

1. reduction of rural poverty
2. modernization and diversification of the rural economic base
3. economic integration of subsistence agricultural households
4. creation of nonfarm jobs to absorb labor released from agriculture
5. EU accession

A modernized, efficient agriculture will release labor, increasing unemployment unless new jobs are created. In order to reduce the personal and public costs of dislocation, it is highly desirable that as many of these jobs as possible be located in rural areas. Agricultural modernization without rural job creation will create stress on urban areas as well as rural areas. Furthermore, under conditions of global competition, agriculture will be unable to generate sufficient income to support the infrastructure, public services, and private services needed for a high quality of life. Rural Ukraine must have a diversified economy based on both agricultural and nonagricultural enterprises.

Complete elimination of rural poverty is unrealistic, but reduction of rural poverty, at least to levels comparable to urban poverty, is an achievable and desirable goal.

Accession to the EU is a meritorious goal for many reasons, including macroeconomic stability, increased economic integration, expanded markets, and, for some time at least, increased economic aid.

Research in numerous underdeveloped rural regions in many countries has compared and evaluated alternative policies and practices. We have identified the following six best practices that can inform Ukrainian rural policy:

1. moving from sectoral to place-based economic development

2. strengthening public-private partnerships
3. cluster development
4. rural entrepreneurship
5. capacity building rather than dependence-based, top-down development programs
6. strategic investment in human capital, social capital, and infrastructure

Ukraine's history of poor economic performance, hyperinflation, bank failures, frequent policy changes, subsistence farming, and out-migration creates unusual constraints on policy-makers. Of particular concern for rural development policymakers are

1. lack of entrepreneurial tradition
2. lack of strong rural financial institutions
3. uncertainty regarding taxation, regulation, and other policies
4. demographics (an aging population)

Many rural strategies, such as green tourism, agricultural value adding, and entrepreneurship, must be a part of an effective rural development policy. Here we outline some “big picture” ideas and some necessary processes for making other ideas work.

- **Improve rural infrastructure**—adequate infrastructure is a necessary condition for competitive agriculture and nonagricultural businesses in rural Ukraine.
- **Create a rural development support system**, including a state agency for rural development; a rural policy coordinating council; a process for public participation in policy development; and an independent rural policy observatory.

The most significant needed departures from current rural development policy are

- **An aggressive, comprehensive, revolutionary national extension service.** This new institution should not simply emulate the systems in other countries, but go beyond these to a system suitable for the twenty-first century. A national extension system should become the key component of Ukraine's rural development policy. The consequences of this policy would be more rapid advancements in agricultural development, higher success rates for rural businesses, rising incomes in rural areas, and the creation of a network of trained extension agents placed throughout the country. It is critical that this go well beyond agriculture extension to cover nonfarm rural business and entrepreneurship.
- **An aggressive capacity-building program to create sustainable rural governance traditions and institutions** in rural Ukraine. It is essential that Ukrainians create a capacity-building program similar to the EU's LEADER+ program or Canada's Community Futures Program. Both of these programs have proven successful in encouraging and supporting bottom-up development programs in areas where there was not a strong tradition of local government. This policy shift will be highly compatible with the goal of governmental decentralization.

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Policy goals for rural Ukraine

A large portion—about 30 percent—of the Ukrainian population live in rural areas.¹ As previous chapters have indicated, the economy of rural Ukraine is primarily based on agriculture. The agricultural sector has undergone significant turmoil since independence, leaving many residents trapped in subsistence and subsidiary agriculture as a survival strategy. Rural development policy must help rural Ukraine transform itself. In order to do so, five specific goals for rural development policy must be achieved: reduction of rural poverty; modernization and diversification of the rural economic base; economic integration of subsistence agricultural households; creation of nonfarm jobs to absorb labor released from agriculture; and EU accession. Each goal is discussed below.

Reduction of rural poverty

Ukraine has no official definition of poverty. The Institute for Economic Research and Policy Consulting (IER) has studied rural and urban poverty in Ukraine based on the 2001 survey of households. They calculate poverty rates using two different measures. First, they follow the World Bank in defining individuals as “poor” if they have less than US\$1 to spend per day. The IER refers to this as Type I poverty. The World Bank’s criterion, however, may overstate the level of poverty in Ukraine. According to the IER, at the time of their study, the Ukraine hryvnia (UAH) had significantly more purchasing power than the official exchange rate between the U.S. dollar and the UAH would suggest. An alternative measure of poverty, which defines people as “poor” if they spend more than 80 percent of their income on food, is unaffected by the official exchange rate. This is referred to as Type II poverty.

Based on data from the 2001 census, the Type II poverty rate was estimated at 27 percent for rural Ukraine, compared to 10 percent in urban areas and 14 percent for the country as a whole.² The distribution of poverty across the various regions of Ukraine is shown in table 6.1.

In total, about 18.4 million persons are classified as poor under the Type I poverty definition and about 7 million under the Type II poverty definition. As can be seen from the table, Type I poverty dominates rural areas, with the gap in poverty between rural and urban areas being the largest in the southern part of Ukraine.

The income gap can be defined as the amount of additional income, considered as a percentage of the poverty line income, that would be needed to eliminate poverty. This calculation shows that the deficit of those living in poverty (Type I) in Ukraine is about 28 percent. In all cases, the rural poverty gap exceeds the urban poverty gap.

1 “Rural” is used here consistent with the definition in the *Yearbook 2003* (State Statistics Committee of Ukraine 2004), in which “rural” is any settlement but urban. Urban areas are settlements that are legislatively recognized towns or townships.

2 The Type I definition yields poverty rates much higher than those reported above. Type I poverty is estimated at 45 percent for rural areas, 38 percent for urban areas, and 39 percent for the national average.

Complete elimination of rural poverty is unrealistic, certainly in the foreseeable future, but reduction of rural poverty, at least to levels comparable to urban poverty, is an achievable goal. Such a reduction would mean that macroeconomic and other national policies could be expected to function equally well in improving the quality of life in rural and urban areas of the country.

Table 4.1. Distribution of rural and urban poverty across the regions of Ukraine, 2001

	Percentage of people living below the Type I poverty line (million persons)	Percentage of people living below the Type II poverty line (million persons)	Income gap** (percent)
West*			
Rural	49 (2.7)	28 (1.5)	27.8
Urban	45 (2.4)	9 (0.5)	27.2
North			
Rural	40 (0.9)	29 (0.7)	29.2
Urban	37 (1.3)	10 (0.3)	26.6
Center			
Rural	43 (1.2)	24 (0.6)	28.2
Urban	36 (1.2)	6 (0.2)	25.6
East			
Rural	35 (0.9)	19 (0.5)	30.7
Urban	35 (4.7)	11 (1.4)	26.9
South			
Rural	51 (1.3)	26 (0.7)	34.3
Urban	40 (1.8)	11 (0.5)	29.1
Ukraine	39 (18.4)	14 (6.9)	27.9

Source: author's own calculations on the basis of the household survey reported by Galushko 2004.

* **West:** Transcarpathian, Lviv, Volyn, Ivano-Frankivsk, Ternopil, Rivne, Khmelnytsky, and Chernivtsi oblasts;

North: Zhytomyr, Kiev, Chernigiv, and Sumy oblasts; **Center:** Vinnytsya, Cherkasy, Poltava, and Kirovograd oblasts;

East: Kharkiv, Dnipropetrovsk, Zaporizhzhya, Donetsk, and Lugansk oblasts; **South:** Odesa, Mykolaiv, and Kherson oblasts and the Crimean Autonomous Republic.

** The income gap can be calculated from information on the income of individuals as follows:

$$IGR = 100 \sum_{i=1}^q \frac{(P - y_i)}{qP}$$

IGR stands for income gap,

P—Type I poverty line,

y_i—income of the *i*th individual in poverty,

q—the total number of persons in poverty.

Modernization and diversification of the rural economic base

Modernization of agriculture, which is dealt with more directly elsewhere in this volume, is a precondition for rural development. Agriculture currently absorbs about 30 percent of the country's labor force. Modernization of agriculture is needed to free this labor force so that it can be employed more productively in other sectors of the Ukrainian economy.

An important aspect of agricultural modernization will be its diversification. A diverse agriculture will be more stable in the face of global competition and will provide a more robust basis for a stable, growing rural economy. Of course, scale is important, and in order to achieve sufficient sectoral scale, agriculture may specialize in clusters in regions of the country (e.g., vegetables/fruits and wine, for example).

But agriculture alone is never able to support a sustainable, stable, and vibrant rural economy. As agriculture develops, it employs fewer and fewer workers, and as it competes globally it generates narrower margins, until it is unable to generate sufficient income to support the infrastructure, public services, and private services needed for a high quality of life.

Economic integration of subsistence agricultural households

Low-income subsistence agriculture is unsustainable in a modern, productive economy. Economic integration will enhance the functioning of the land market, the labor market, and local government. In addition, it will increase quality of life for millions of rural residents.

Creation of nonfarm jobs to absorb labor released from agriculture

A modernized, efficient agriculture will release labor, increasing unemployment unless new jobs are created. Depending on the speed of this process, the need for alternative employment could be very significant. In order to reduce the personal and public costs of dislocation, it is highly desirable that as many of these new jobs as possible be located in rural areas. Agricultural modernization without rural job creation will create stress on urban areas, as well as rural ones. It is in the interest of all citizens to avoid this outcome through proactive measures to create rural nonfarm jobs and provide retraining opportunities for rural workers.

Table 4.2 provides a national as well as spatial profile of employment in rural Ukraine. The table shows that approximately 71 percent of the rural population in Ukraine is nonemployed, encompassing unemployed members of the active labor force, pensioners, pupils, students, etc. A significant share of the rural population is employed in agriculture (about 11 percent), but approximately the same share is employed in nonfarm activities (education, healthcare, the extracting industry, etc.). However, one should take into account the specifics of rural life in Ukraine. Many of those involved in nonfarm activities spend a considerable amount of time in subsistence or subsidiary farming activities as well. Regionally, the nonfarm employment profile is approximately

Table 4.2: Sectoral profile of rural employment, Ukraine, 2003
(percentage of population)

Sector	Ukraine	West*	North	Center	South	East
Agriculture	10.8	6.6	10.5	10.4	15.2	13.9
Fishery	0.2	0.1	0.2	0.1	0.6	0.1
Extracting industry	0.4	0.3	0.1	0.1	**	1.5
Processing industry	2.2	3.4	2.6	3.0	0.6	0.9
Electricity, gas, and water supply	0.4	0.7	0.1	0.5	0.6	**
Construction	1.8	1.0	1.8	0.8	1.2	0.9
Wholesale and retail sales	1.1	1.6	2.0	1.8	1.7	1.7
Hotels	0.1	0.1	0.1	8	0.1	**
Transport and communication	2.2	1.9	2.3	1.9	3.3	2.4
Finance	0.1	0.1	0.2	0.1	**	0.2
Real estate	**	0.1	**	0.1	**	**
State government	1.4	1.5	2.0	1.0	1.4	1.2
Education	3.3	3.9	3.2	3.4	2.8	2.4
Healthcare	2.6	3.0	3.1	2.2	3.1	1.8
Public services	0.5	0.5	0.3	0.3	0.4	1.1
Servants	**	**	**	**	**	0.1
Exteritorial activities	**	**	**	**	**	**
Nonemployed (pensioners, pupils, students, unemployed, children, etc.)	72.8	75.2	71.4	74.0	68.9	71.8

Source: author's own calculations on the basis of the household survey reported by Galushko 2004.

* **West:** Transcarpathian, Lviv, Volyn, Ivano-Frankivsk, Ternopil, Rivne, Khmelnytsky, and Chernivtsi oblasts; **North:** Zhytomyr, Kiev, Chernigiv, and Sumy oblasts; **Center:** Vinnytsya, Cherkasy, Poltava, and Kirovograd oblasts; **East:** Kharkiv, Dnipropetrovsk, Zaporizhzhya, Donetsk, and Lugansk oblasts; **South:** Odesa, Mykolaiv, and Kherson oblasts and the Crimean Autonomous Republic.

** Less than .05%.

Note: Percentages may not sum to 100 because of rounding.

the same across all regions. The most important sectors, in terms of rural employment, are the processing industry, wholesale and retail trade, transport, and education. The relative importance of employment in agriculture largely reflects the degree of agricul-

tural specialization. For example, Ukraine's South and East regions, the leaders in agricultural production, employ higher percentages of the rural population in agriculture.

EU accession

Accession to the EU is a meritorious goal for many reasons, including macroeconomic stability, increased economic integration, expanded markets, and, for some time at least, increased economic aid. Even though the day of accession may seem far away, the experience of recent new member states from Central and Eastern Europe indicates that the measures taken in preparation for accession were very beneficial in building more competitive and stable economies.

Trends and best practices in rural development policy options and processes

Rural development policy in developed and developing nations has evolved rapidly in the last decade. Research in numerous underdeveloped rural regions in many countries has compared and evaluated alternative policies and practices. In 2002, rural development experts from around the world met in Siena, Italy, at the invitation of the OECD, to discuss the future of rural policy. The conferees concluded that rural policy is evolving, summarizing the emerging best practices as follows (OECD 2003, 20):

- enhancing “competitiveness” of rural regions by targeting local collective goods (amenities, clusters, etc.) as a means of generating new competitive advantages
- shifting from an approach based on subsidising declining sectors to one based on strategic investments in order to develop new enterprises in new activities (including agri-tourism or eco-tourism) and diversify the local economy
- shifting from a sectoral to a place-based approach, including attempts to improve co-ordination and to integrate the various sectoral policies at regional and local levels
- promoting framework conditions in fields such as logistics and business infrastructures for upgrading product standards and promoting labelling in order to support or attract enterprises indirectly
- enhancing business assistance and networks of knowledge and expertise to diffuse new technologies
- developing human resources through vocational training, including an important emphasis on entrepreneurial skills, and “capacity building” for policy actors at local levels
- ensuring new ways of providing public services in sparsely populated areas, combining service centres and distance learning through information and communications technologies

From this and other reports we have identified the following six best practices that can inform Ukrainian rural policy:

Moving from sectoral to place-based policy

Sectoral policy, such as agricultural policy, is necessary to modernize, diversify, and increase the competitiveness of individual sectors. But sector policy is incapable of solving territorial issues, such as rural poverty, inadequate infrastructure, or even the creation of nonagricultural jobs. The recapitulation by Margaret Clark (2003, 8) in the recent OECD report sums it up well:

Policies and subsidies focused on sectors, such as agriculture, tourism, etc., miss the diversity of rural areas and will not meet the needs of today. There is growing acceptance of the need for place-based policies which recognize and build on the opportunities and advantages of areas or which seek to tackle their disadvantages.

Strengthening public-private partnerships

Developed economies are increasingly finding that partnerships between the public and private sectors lead to better results than can be achieved by either sector separately. The private sector offers innovative solutions and flexibility, while the public sector offers sources of revenue and statutory power. A number of examples may be cited where these partnerships have been very successful in supporting underdeveloped regions within developed economies. A partial list of the types of projects possible includes roads and highways, schools, water systems, and communication systems.

However, this type of strategy requires high levels of trust, accountability, and transparency, none of which may be in sufficient supply in an emerging market economy. In fact, one of the most common reasons for the failure of public-private partnerships is less-than-complete commitment on the part of the partners (United Nations Foundation 2003).

Cluster development

Economic clusters are spatial concentrations of firms that complement each other economically. While the best-known clusters occur in urbanized areas of advanced economies, this strategy has been successfully employed in a number of rural areas. As the OECD (2003, 18) concluded:

Amenity-based development and industrial clustering seem to offer sustainable prospects for more rural areas than those already benefiting from them.

The best known of these are tourism and agricultural sectors in places like Napa Valley, California; the Tuscany region of Italy; the toymaking cluster in Ibi, Valencia, Spain (Regional Technology Services, Inc.); and the Lubartow agrotourism region of Poland (Syzmoniuk).

Table 4.3. Profile of rural employment by type, Ukraine, 2003 (percentage of total)

Type of Employment	Ukraine	West*	North	Center	South	East
Hired persons	27.1	24.8	28.5	25.9	31.0	28.2
Entrepreneurs (with hired persons)	0.1	0.1	0.2	**	0.1	**
Self-employed (without hired persons)	2.0	3.7	0.5	1.0	2.1	0.5
Subsistence and subsidiary farming	0.2	0.4	**	**	**	**
Nonemployed (pensioners, pupils, students, unemployed, children, etc.)	70.6	70.9	70.8	73.0	66.8	71.3

Source: Author's own calculations on the basis of the household survey reported by Galushko 2004.

* **West:** Transcarpathian, Lviv, Volyn, Ivano-Frankivsk, Ternopil, Rivne, Khmelnytsky, and Chernivtsi oblasts; **North:** Zhytomyr, Kyiv, Chernigiv, and Sumy oblasts; **Center:** Vinnytsya, Cherkasy, Poltava, and Kirovograd oblasts; **East:** Kharkiv, Dnipropetrovsk, Zaporizhzhya, Donetsk, and Lugansk oblasts; **South:** Odesa, Mykolaiv, and Kherson oblasts and the Crimean Autonomous Republic.

** Less than .05%.

Note: Percentages may not sum to 100 because of rounding.

Rural entrepreneurship

Entrepreneurship is the basis for much economic development, and in most countries, farmers and other rural residents have been among the most entrepreneurial segments. Despite significant obstacles (discussed in a later section), it is widely agreed that entrepreneurship is essential to the development of the Ukrainian, and particularly rural Ukrainian, economy.

Less is known about rural entrepreneurship than about entrepreneurship that springs up in the urban business agglomerations. The scale of rural entrepreneurship is almost necessarily smaller, the risks greater, and the support services usually less developed in rural areas, yet examples of successful rural entrepreneurs abound (see Institute for Rural Development et al. 2003).

If we look at the profile of employment in rural areas of Ukraine we will notice that entrepreneurs and self-employed persons constitute only a small fraction of the total rural population, with almost negligible differences across the regions (table 4.3). By contrast, hired workers constitute the majority of the total employed rural population.

Research on rural entrepreneurship in advanced economies shows that locally provided public services and informal networks among rural entrepreneurs are essential to successful rural entrepreneurship (Chatman and Johnson 2005).

Capacity building rather than dependence-based, top-down development programs

Research into the determinants of development in rural regions consistently supports the hypothesis that development is more effective and sustainable when residents of rural areas take greater responsibility for change in their communities. Top-down policy, while possibly less risky—and more complicated, from the state's perspective—is usually less sustainable. Margaret Clark (2003, 8), writing for the OECD, concludes:

There are clear moves away from centralised “top-down” policy and delivery towards more local “bottom-up” approaches within an agreed policy framework, although there are still issues about the balance between these and what institutions and governance are needed in support.

Bottom-up policy requires patience and several preconditions, including policymaking capacity at the local level, strong systems for accountability, effective program assessment capacity, and institutions to permit the vertical coordination of governments.

In evaluating the EU's LEADER (Links between Actions for the Development of the Rural Economy) program, Van Depoele (2003, 83) describes the bottom-up approach as follows:

The bottom-up approach has four levels of participation: (1) *Information* through public meetings for the entire community (farmers, nonfarmers, residents, etc.). (2) *Consultation* or a kind of “village audit” of active community groups. (3) *Joint development* of projects by the Local Action Group. (4) *Collective decision making* concerning actions and strategies.

The advantages of the bottom-up approach are: more clearly identified local problems and needs; better organisation of development players; better understanding of local decisions by the community; greater acceptance of local decisions by the higher authorities and stimulation of ideas and projects leading to innovative local actions.

Also referring to the LEADER programs, Mantino (2003, 171) describes some of the relationships between the state (in this case the EU) and local or regional governments necessary to ensure sound rural development programs. Among other things, he suggests these two strategies:

a system of rural development policy planning based on three vital principles: mechanisms to reward the quality of a strategy, more resources earmarked for innovative interventions, a simpler system for approving aid management for enterprises;

... a rural development policy management system which includes a system of penalties and rewards, not only for those who prove capable of spending rapidly, but also and more especially for those programmes which achieve quantified ob-

jectives, adopt best practice, and encourage the adoption of significant innovations in the institutional system and territory concerned.

This strategy of vertical coordination among governments is more directly relevant to the next chapter on decentralizing government administration, but it has been consistently found to be important in rural development policy and is relevant here as well.

Strategic investment in human capital, social capital, and infrastructure

Among the conclusions that Margaret Clark (2003, 8) drew following the OECD conference on rural development policy was that experience in successful rural development underscored

the importance of infrastructure, such as communications, ICT [information and communication technology], and enhancing social capital to increase the competitiveness of rural areas. The capacity of local people and organisations to participate, however, needs reinforcing. How do we find tomorrow's leaders and entrepreneurs?

Most empirical research supports the hypothesis that leadership, education, social capital, and infrastructure are necessary conditions for rural development.

High-quality infrastructure will generate benefits far into the future. It not only improves quality of life directly, but it will help achieve all the other goals—agricultural modernization and nonfarm job creation in particular—by reducing costs of production and by attracting and retaining skilled workers. And while it is true that the old infrastructures (roads, public buildings, utilities) should not be ignored. Rural Ukraine may be able to leapfrog into advanced infrastructure. At a minimum, the old types of infrastructure should be built with new information and communication infrastructure in mind. Buildings, for example, should be built to accommodate information technology.

Policy constraints

The first two sections of this chapter laid out the overriding goals of Ukrainian rural development policy and reviewed some of the policy strategies being used in other countries around the world. The particular choice of policy strategy depends not only on the goals and policy options, but also on the unique constraints facing the policymaker in the country in question.

Ukraine's recent history makes its situation quite unusual even among transitional economies. Its history of poor economic performance, hyperinflation, bank failures, frequent policy changes, subsistence farming, and out-migration creates unusual constraints on policymakers. This section reviews four of the most significant policy constraints.

Lack of an entrepreneurial tradition

In transitional economies there is often a deep distrust of entrepreneurs and entrepreneurial activities which predates socialism (Kalantaridis 2004). More recently, this distrust has been magnified by the unethical and corrupt activities of some entrepreneurs. Furthermore, entrepreneurship has often been stifled and repressed by protection from competition and other paternalistic policies.

Rural entrepreneurship presents special challenges to the Ukrainian policymaker. The little research available on this topic suggests that rural entrepreneurs are significantly different from urban entrepreneurs in several aspects. Reporting on a 2000 survey of rural entrepreneurs in the Transcarpathia region, Kalantaridis (2004) identified four categories of entrepreneurs. The old Soviet directors made up 17 percent of those interviewed, petty traders made up 14 percent, petty entrepreneurs comprised 58 percent, and 11 percent were new capitalist entrepreneurs. The old Soviet directors were predominantly men who were in positions of influence during privatization and were able to convert this influence into ownership stakes in privatized businesses. The petty traders and petty entrepreneurs (including commercial farmers) were younger and more likely to have been “pushed” into entrepreneurial activity by unemployment or lack of opportunity. Most entrepreneurs reported that they owned three or more enterprises, and roughly three-quarters had lived in an urban area at some point.

Of these four types, the new capitalist entrepreneurs were seen as the most relevant to rural development policy. They differed from other categories in age (older than petty entrepreneurs and traders, but younger than the old Soviet directors). They were more dependent on local information networks and partnerships, and less educated. Kalantaridis concludes that this group differs “profoundly from the urban-based new generation business people.” In rural areas, new capitalists are older and less educated. This suggests that they have located in rural areas, or are staying there, in order to exploit their networks and opportunities. It also suggests that an opportunity exists to develop the rural petty entrepreneurs into new capitalists. Among other things, they must learn to exploit networks and partnerships rather than seeing others only as competitors.

While the situation may have changed somewhat since 2000, this research suggests several challenges—but also potential opportunities and strategies—for policymakers. First, the stigma attached to entrepreneurship must be erased. Entrepreneurship must be seen as a positive activity that has spillover benefits all around. An obvious first step is to ensure that entrepreneurs have strong incentives to operate legally and ethically. Improving the image of entrepreneurs will do much to increase the “pull” into entrepreneurial activities, replacing the current “push” from unemployment or low incomes.

Second, we must better understand the barriers facing young and well-educated residents of rural Ukraine so that they can be given the tools they need to become more entrepreneurial. Clearly, young rural Ukrainians, including women (in the petty

trade category), are trying entrepreneurship as an option. But they need to have better education, role models, and resources.

Third, networking among entrepreneurs must be encouraged. The current lack of networks is related to the image that rural residents have of entrepreneurs. A positive image will make networking with other entrepreneurs more socially acceptable.

Fourth, the research demonstrates the importance of attracting expatriates back to rural areas. Those who have urban experience are most likely to start new businesses when they return to rural areas. They bring fresh ideas, broader connections and networks, and sometimes capital.

Lack of strong rural financial institutions

Given the country's history of hyperinflation and bank failures, it is perhaps not surprising that Ukrainians are uneasy with the concepts of bank savings and loans. Anecdotal evidence suggests that much of the investment capital currently financing businesses is bypassing the formal financial system. Informal or "angel" investors are providing a significant portion of the financing, especially for more entrepreneurial endeavors. While angel investing is in itself an important and positive part of an entrepreneurial economy, too much dependence on this segment of the financial sector suggests the failure of more traditional segments to meet the demand for financial capital.

Another indicator of the constraint presented by the underdeveloped financial sector is the high real interest rates, as well as the large gap between saving and lending rates. Kozanchenko and Demyanenko (forthcoming, 25) point out, this gap is several times greater than in EU countries. At least part of this problem can be attributed to the protection afforded the formal banking sector by regulatory barriers to entry.

Uncertainty regarding taxation, regulation, and other policies for nonagricultural enterprises

Rural development requires large investments of private capital in job-creating activities. Investments require confidence in the economy and the ability to earn a reasonable rate of return over a period of time. Shifting policies change the prospects for businesses and make future earnings less certain. Thus rational investors demand a faster payback on investments, which eliminates many otherwise promising investment opportunities. By contrast, a stable policy environment, or even one which is changing but in a predictable manner, will accelerate economic development. Unfortunately, improvements in policy require changes in policy. But the clear articulation of the principles, goals and plans guiding such policy changes, if believed by investors, would do a great deal in itself for rural development in Ukraine.

Demographics: Ukraine's aging population

As in many parts of the world, the demographics of rural Ukraine place a significant constraint on policymaking. The residents of rural Ukraine are, on average, older than

urban residents, making the dependency rate³ much higher (as tables 6.2 and 6.3 indicate, pensioners make up a large share of the nonemployed). A high dependency rate means that relatively more personal income and tax revenues must be devoted to the care of the young and old, and less is available for investment in economic development. Making rural areas attractive to people in the most productive age groups, then, is a precondition for sustainable rural development. Current youth, recent out-migrants, and expatriates must believe that they can enjoy a standard of living comparable with that in urban areas. This will require a wide range of public and private services as well as infrastructure.

Policy options and consequences

In this section, from among the best practices and proven approaches to rural development, we choose those most likely to be feasible, given the constraints facing rural Ukraine. The four policy options below are not alternatives. In fact, they are quite complementary.

Development of a national extension system

We propose that a national extension system become the key component of Ukraine's rural development policy. This service should go beyond agricultural extension to encompass all the continuing-education and technical assistance needs of rural Ukraine. The continuing education of the Ukrainian population is a legitimate public sector role because of the significant external benefits that flow from a productive and knowledgeable population.

Currently there are several very successful examples of how effective information dissemination and technical assistance can be at improving the lives of rural people in Ukraine. There are several models for extension in different parts of the country. This multiyear and multidimensional experiment with extension provides an important opportunity for Ukraine to compare alternative models and to evolve toward a first-rate extension system designed for the twenty-first century. But since the current services are experimental, and largely funded by donor nations, they are not sustainable. Immediate action is required to preserve the progress achieved and to make the system sustainable. Also required is a multiplication of effort to extend this system to every region and to every sector of the rural economy.

Legislation to create a national extension service has already been enacted and awaits implementation.⁴ The first step in implementing this policy is to conduct a thorough analysis of the strengths and weakness of the various extension models and to compare the findings of this analysis with the model proposed by the pending legislation. Furthermore, this assessment should not be considered a one-time task,

3 The dependency rate is the ratio of the nonworkforce-age population (i.e., older or younger than the workforce age) to the workforce-age population.

4 Ukraine Law N1807-IV, "On Agricultural Extension Services," enacted June 17, 2004.

but rather the beginning of a continuous quality improvement process for the national extension program.

The second implementation step would be to craft an inclusive structure for a Ukrainian extension service based on the assessment in the previous step. Ideally, this structure will allow for continuing experimentation and include public, private, and not-for-profit participation. It would accommodate international donors but would be primarily funded by the government of Ukraine at the national, oblast (province), and rayon (district) levels. It should employ information and communication technology to deliver services and to coordinate the components. It is important that this structure create functional links between extension activities and research institutions. These links are important not only so that extension will have access to the best and newest information to deliver to rural residents, but also—and this is equally important—so the researchers learn more about the issues and needs of rural residents, businesses, and governments.

The third step is to plan a schedule for increasing the funding for extension. This schedule should increase both the breadth and depth of extension, as quickly as human and financial resources can be reallocated. Increased funding for extension should be accompanied by reduced subsidies to other parts of the Ukrainian economy. Extension should be the primary support mechanism for agricultural and nonagricultural industries alike in rural areas.

The fourth step would be the development of extension programs for rural areas. Suggested programs would include

- rural entrepreneurship training and support
- development of a system of community learning resource centers, equipped with broadband internet connections, continuing education facilities, libraries, extension offices, small-business development centers, and possibly other facilities as determined by the communities

The consequences of this policy would be more rapid advances in agricultural development, higher success rates for rural businesses, rising incomes in rural areas, and creation of a network of trained extension agents placed throughout the country.

Create a rural development support system

Effective rural development programs start by creating capacity in rural populations to solve their own problems. Rural issues cut across sectors, governments, and agencies, and thus require a horizontal policy response. A rural development support system provides rural residents and local governments with information, coordination, and technical assistance. They then decide how to combine these resources with their own to bring about the results they want.

A rural development support system would include some or all of the following steps:

- creation of a state agency for rural development
- creation of a rural policy coordinating council to assure that all policies and programs of the government of Ukraine complement and support rural development
- development of a process for public participation in policy development (like the Rural Dialogue program in Canada)
- creation of an independent rural policy observatory, to suggest alternative rural development policy changes and to monitor and assess the success of rural development programs

Improve infrastructure

Adequate infrastructure is a necessary condition for competitive agricultural and non-agricultural business in rural Ukraine. In addition, it will contribute directly to quality of life in rural areas. Infrastructure effectively subsidizes all businesses and families yet is considered a “green box” provision by the WTO (i.e., a subsidy that causes little or no distortion).

Particular infrastructure needs will vary from place to place, but will include such things as roads and highways, schools and childcare facilities, hospitals and clinics, and community centers with libraries, internet connections, and adult learning facilities. Priorities and the general features of these facilities should be determined by local residents, but communities should be encouraged to build with the future in mind.

Strengthen local economic and community development capacity

It is essential that Ukrainians create a capacity-building program similar to the EU LEADER+ initiative and Canada’s Community Futures Program. Both of these programs have proven successful in encouraging and supporting bottom-up development programs in areas where there was not a strong tradition of local government.

Local economic development groups will require significant support from the state, however. Of particular concern is the lack of strong financial institutions in all of Ukraine, but particularly in rural areas. Effective financial institutions do more than just provide capital. When they are effective, financial institutions accurately identify the degree of risk involved in proposed ventures, screen out those that are too risky, provide counseling to reduce the risk involved in other proposals, and provide ongoing advice and technical assistance to ventures that are funded.

While a thorough analysis of economic development needs is required for each region of Ukraine, some of the following will be appropriate in many regions:

- A program patterned after the EU’s LEADER+ initiative. The EU should be asked to provide assistance in setting up such a program.
- A partial (20–50 percent) loan guarantee program for public and private economic development projects. A loan guarantee program will strengthen

the private banking system rather than compete with it, as a government loan program would do. The result should be to create an efficient, effective private financial sector rather than to simply provide access to credit.

- Encouragement of microloan programs, such as the one recently initiated in Ukraine by the European Bank for Reconstruction and Development. Again, these should be provided by rural financial institutions but should directly involve local economic development groups.

The consequences of these policies would be a gradual but prolonged growth in local involvement in economic development activities, a growth in entrepreneurial activity, and a strengthening of the financial sector. These programs would be consistent with Ukraine's EU and WTO aspirations.

Concluding remarks

Agricultural policy and rural development policy goals, principles, and constraints are different. At the same time, sound rural development policies will enhance the competitiveness and development of agriculture, and sound agricultural policy will enhance the effectiveness of rural development policy.

The most significant needed departures from current rural development policy identified in this chapter are

- an aggressive, comprehensive, revolutionary national extension service: this new institution should not simply emulate the systems in other countries, but go beyond these to a system suitable for the twenty-first century
- an aggressive capacity-building program to create sustainable rural governance traditions and institutions in rural Ukraine: this policy shift will be highly compatible with the goal of governmental decentralization discussed in the next chapter

Ukraine's rural areas will necessarily undergo enormous adjustment as the country's primary sector, agriculture, modernizes and becomes globally competitive and as the economy diversifies into nonagricultural sectors. The consequences of this adjustment will have profound effects on both rural and urban economies. Without effective policies to prepare for and accommodate this change, massive dislocation will occur. An aggressive policy response such as that described above is required.

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Decentralizing Government Administration

Thomas G. Johnson

EXECUTIVE SUMMARY

A prerequisite for economic development in Ukrainian agriculture and rural economies is sound government and governance at all levels and throughout the country. Sound governance enhances the productivity of the private sector and improves the quality of life of residents.

We propose the following goals for rural governance policy in Ukraine:

- maximization of economic performance
- efficient provision of public services
- fairness of taxation and access to public services

Rural governance is an important key to sustainable economic development. The current best practices in governance include

- decentralization, devolution, and subsidiarity of government functions
- regional governance
- transparency and accountability
- public-private partnerships in policymaking and implementation

We have identified the following constraints that must be recognized if rural governance is to be improved:

- corruption
- lack of a local governance tradition
- a weak system of public finance

The government of Ukraine is planning a thorough reorganization of local governments. The key to the success of this plan is the decentralization or devolution of financing authority as well as responsibility to lower levels of government. The proposed policy strategies in this paper suggest a process for transforming rural local governments into real partners in economic growth.

Aggressive anticorruption programs

Some of the anticorruption strategies known to work include:

- privatization
- streamlined government procedures
- improved accountability
- improved incentives for public officials
- strong civil society organizations

Local government tax reform

Efficient and effective local and regional governments require stable, robust sources of revenue. As general principles, subsidies should be reserved for activities that are considered meritorious and underprovided, while extraordinary taxes should be applied to activities that are considered deleterious and/or overproduced. These principles suggest the following strategies for local governments:

- elimination of tax exemptions
- increased use of land tax and value-added tax
- greater reliance on user fees to finance public services

Reorganization of local government entities

The population of rural Ukraine is going to change dramatically over the next generation, and the government structure must be built to accommodate these changes. The ideal way for the boundaries of local governments to be determined would be for their residents to decide among themselves. This may not be possible during the initial reorganization, but a low-cost procedure for redistricting would be ideal, with incentives built in to redistrict when appropriate.

Increased capacity of rural governments

The dramatic changes in governance will require a significant increase in the capacity of local leaders to make decisions, manage resources, and instill confidence in their constituents. We recommend the following:

- public administration education programs
- e-government
- promotion of civil society



Goals for rural governance

Effective governance is an amalgam of specific practices that make the difference between stagnating and flourishing communities. —*Nancy Stark (2005, 1)*

A prerequisite for economic development in Ukrainian agriculture and rural economies is sound government and governance¹ at all levels and throughout the country, but especially rural governments. Sound governance enhances the productivity of the private sector and improves the quality of life of residents. There are many potential competing goals for rural governance. The United Nations Development Program, among others, has identified the characteristics of good governance as participation, rule of law, transparency, responsiveness, consensus orientation, equity, effectiveness, efficiency, accountability, and strategic vision (UNDP, 1997). These characteristics suggest the following goals for rural governance policy in Ukraine:

Maximization of economic performance

The first goal of governance is to maximize the short-term and long-term performance of the economy. To do this, it must first distort the decisions made by private and public decisionmakers as little as possible. Taxes are necessary to fund public services and government, but change the relative costs and benefits of various behaviors. While they are useful means of reducing undesirable behavior, they also discourage positive economic activities. Similarly, government spending, subsidization, and transfers also affect behavior. Subsidies are sometimes useful means of encouraging certain activities (such as public education), but they often encourage less desirable behavior, such as overproduction and inefficient investments.

Taxes distort when they discourage economic activity that would otherwise be profitable and beneficial. The amount of distortion depends on the response elasticity of the activity or tax base. Some tax bases are more mobile than others. Land is immobile, while labor and certain services are highly mobile. Factories, retail and wholesale facilities, and similar assets are immobile in the short and medium term. Economic performance will be better when more mobile assets are taxed less heavily.

Taxes that correspond to particular public services (sometimes called user fees) rationalize the use of public services, influencing behavior in a desirable fashion.

Efficient provision of public services

Public services and infrastructure are essential to economic performance and quality of life, but in the absence of competitive forces, effective governance is necessary to

1 “Government” usually refers to the implementation of policy, administration of programs, enforcement of regulations, and provision of public services by the official ruling power in a polity. “Governance” refers to the process in which a polity’s citizens and its decisionmakers interact to administer the polity, e.g., to choose governments, express policy preferences, select policy, and create governmental and nongovernmental institutions.

ensure the efficient production of public services. Effective governance ensures that the taxpayers have influence over the delivery of the services.

Another necessary condition for efficient service production is the placement of responsibility for public services at the appropriate level of government. The appropriate governmental level is that level (local, oblast, regional, or central) at which the service will be produced at the optimum level and at minimum cost. Public services with significantly large spatial spillover effects can be most efficiently provided at the oblast (provincial) or central government level. Alternatively, they can be produced at the local level but funded through conditional transfers of funds from the central government to local governments. Public services subject to significant economies of scale will be best provided at the central government level. Most services are best delivered at the local level if the system of governance, especially accountability, is adequate.

Fairness

A third goal of rural governance is fairness or equity. Fairness and equity require government to calibrate its tax collections, subsidies to individuals and firms, access to services and infrastructure, regulations, and policymaking process in such a way that no particular groups or classes of individuals are disadvantaged. A highly subjective goal, fairness may never be completely agreed upon and will rarely be completely achieved.

Trends and best practices in governance policy and processes

Governance, especially at the local, regional, and rural level, has received a great deal of attention by researchers and policy analysts over the last decade. A number of international, national, and regional organizations have identified governance as an important key to sustainable rural economic development (Stark 2005; OECD 2005; Lovan, Murray, and Shaffer 2004; Drabenstott et al. 2004; UNDP 1997; Keating 2001).

Good governance has been linked to economic growth and development in many regions and communities. According to a recent paper by Stark (2005, 2), “effective governance incorporates community building: processes that develop leadership, enhance social capital and personal networks, and strengthen a community’s capacity for improvement.”

Here we distill the findings of research on good governance into six key elements. First we look at the trend in many countries to reorganize their government structure, by devolving or decentralizing public functions. The principle commonly evoked in support of reorganized government is “subsidiarity”—a term coined by the European Union to describe their ideal of allocating public responsibilities among EU, member-state, regional, and local governments.

Next we look at regional governance, which is related to, but different from, decentralization. Whereas decentralization refers to the reallocation of public service responsibilities and revenues (vertical coordination), regional governance refers to the

development of new institutions aimed at horizontal coordination of local governments. Then we consider transparency, accountability, and public-private partnerships, which are ways of improving the quality of governance.

Decentralization, devolution, and subsidiarity

States throughout the developed world are turning to decentralization and devolution as ways to make governments more responsive to people's needs and to reflect the diversity of different places and regions.

The UNDP has chosen decentralization and support to local and regional governance as two of its core competencies because this combination “enables people to participate more directly in governance processes and can help empower people previously excluded from decision-making.”

A great deal of attention has been devoted to the issue of decentralization or one of its variations (devolution, subsidiarity, or deconcentration). The 2003 OECD conference (OECD 2003, 23) summarizes this trend as follows:

Diversity among rural places makes it very difficult to design a national policy which can take into account local, specific needs at the same time as geographically balanced objectives of national economic development. Traditional concerns related to fiscal federalism, the effort to secure effective citizen participation in decision making, as well as the necessary consensus to design and implement policy imply an active role for different levels of governments (local, regional, national and international). Many countries have thus embarked upon reviews and reforms moving in the direction of decentralisation and devolution.

Decentralization is more than simply locating central government functions in numerous locations outside the capital city. It is also more than turning over responsibilities for public services to local governments. Decentralization, devolution, and the principle of subsidiarity are about the changing relationships between levels of government. During and following these changes, central governments must remain supportive and committed to their relationship with local governments. Conferees at the 2003 OECD conference concluded (*ibid.*, 24):

At the central government level, there often remains room for improvement in coordinating the various ministries and departments responsible for rural development policies. Judging by recent developments some key elements seem to be: decentralisation towards regions and localities, sometimes involving community “empowerment” efforts in order to better meet the diverse needs and conditions found in rural areas and tap local knowledge and other resources; support for “bottom-up” development initiatives, for example through the Canadian Community Futures Programme and the EU LEADER programme; attempts at better co-ordination of policies affecting rural areas at central levels through

inter-departmental and inter-ministerial working groups or committees, sometimes paralleled by rural affairs committees in national parliaments, and possibly involving various forms of “policy-proofing” to ensure that all policies consider the rural dimension (policy proofing is the process by which a designated body “proof-reads” legislation to verify that rural issues have been adequately considered); allocation of rural co-ordination responsibilities to one senior ministry or department which must chair the inter-departmental or inter-ministerial group; ensure a good flow of information through national or supra-national networks of local partnerships (as for example in the European LEADER Observatory) which exchange information, run training seminars, and provide documentation on “good practice.”

Thus decentralization has been identified over and over again as a desirable means of improving the efficiency and effectiveness of government. Conditions necessary for the success of devolved or decentralized governance include decisionmaking capacity, leadership, and accountability (see below).

Regional governance

To adapt to a scenario of shared authority, territorial dynamics and new economic realities, central administrations have begun to prompt the formation of new structures for territorial governance by encouraging and setting up forms of vertical and/or horizontal co-ordination between the institutional parties involved.
—*OECD 2003, 23*

The motivations for the trend toward regional governance are many (Drabenstott et al. 2004). The primary motivations are the desire for more responsive governments, improved efficiency, and a closer match between the scale of governments and the scale of the public issues governments deal with.

One of the most aggressive experiments in regional governance is that being undertaken in England (Office of the Deputy Prime Minister 2002). Following the successful devolution of significant governmental authority to Scotland, Wales, and Northern Ireland by Great Britain, England chose to create a new system of eight regional governments. The populations of these regions (other than London) average about 5 million, ranging from roughly 2.5 million to over 8 million.

The creation of regional governments in England was intended to effect both devolution and regionalization at the same time. The creation of regional governments was also designed to improve and accommodate connections with the EU. It is hoped that strong regional governance will allow the UK to take better advantage of EU programs and increase the UK's influence in Brussels.

The biggest issues faced when encouraging regional governance are the range of services to be provided by the new governments and the ideal size (population and geographic area) of the regional governments. Smaller governments are closer and

perhaps more responsive to residents, but they have less administrative and policy capacity than larger governments.

Transparency and accountability

In the words of Agustín Carstens (2005), “Transparency and accountability are critical for the efficient functioning of a modern economy and for fostering social well-being.” Yet nations in transition are often unfamiliar with transparency and accountability as characteristics of government. Lack of transparency and accountability inevitably leads to corruption. And as Melissa Rosser of USAID points out (2000, 1),

Public corruption undermines the legitimacy of governments by distorting decision-making processes, weakening institutional capacity and eroding public confidence. It attenuates economic development by inflating the cost of doing business, short-circuiting competition, and diverting budgetary resources away from the provision of public goods and services.

USAID has learned from experience that reducing corruption requires political will, stable government, and a strong and engaged civil society (Rosser 2000, 3).

Transparency and accountability lead to respect for government and greater compliance with laws and regulations, increase the efficiency of tax collection, and reduce the costs of enforcement. Transparency and accountability depend on stakeholders’ access to information—accurate, timely, widely dispersed, and easily understood.

Public-private partnerships

Public-private partnerships are rising in popularity in developed countries. But since corruption often occurs at the interface between public and private activities, and since anticorruption efforts have typically placed restrictions on the relationships between public and private entities, public-private partnerships often require relaxation or modification of these restrictions. For this reason, public-private partnerships may conflict with efforts to reduce corruption and instill greater confidence in government. Thus public-private partnerships work best in countries with mature governmental institutions, strong anticorruption laws and regulations, and strong public ethics.

However, greater transparency and accountability will permit more use of public-private partnerships in Ukraine. And experience shows that institutions can be structured in such a way as to allow ethical operation of public-private partnerships. USAID has learned, for instance, that coalitions of public and private actors can be more effective at combating corruption and making governments more accountable than either public or private institutions can separately. In fact, USAID points to public-private partnerships as the key to successful anticorruption efforts in Donetsk and Lviv oblasts (Rosser 2000, 14).

Thus careful experiments in public-private partnerships, especially those directed

at encouraging accountability and transparency, will permit Ukraine to reap some of the benefits of these mechanisms.

Constraints on Ukrainian governance policy

Corruption

All economies and societies face corruption to some degree. But in 2004, Transparency International's annual Corruption Perceptions Index ranked Ukraine among the most corrupt nations in the world (Transparency International 2004). With a score of 2.2 out of 10, Ukraine tied for 122nd out of 146 countries and fell far short of the 5.0 that Transparency International uses as a threshold dividing economies with serious corruption problems from those without.

Lack of a tradition of local governance

Like many countries, certainly including those from the former Soviet Union, Ukraine does not have a tradition of strong local governance. Without such a tradition, capacity for local and regional governance and public administration will be weak at first. Institutions do not currently exist in Ukraine to ensure transparency and high levels of accountability. Civil society institutions in particular will need to develop and mature in order to perform "watchdog" roles.

Accounting systems, public management systems, and policy analysis procedures will all have to be adapted from other countries or developed within. Managers and administrators will have to be trained, and constituencies will have to become familiar with these procedures. But tradition needs more than learning in order to develop. It will take time for constituents to become comfortable with their new role in governance.

Weak system of local and regional government finance

The Institute for Economic Research and Policy Consulting (IER 2004a) has outlined a number of constraints facing rayon (district) and oblast (provincial) governments at the current time. The problems include:

- unstable local government revenues from local sources
- a high level of dependence of local governments on transfers from the state
- ineffective incentives for central and local government officials to aggressively collect taxes
- a large number of tax exemptions

Together, these problems describe governments that are unable to provide the infrastructure and public services needed for a vibrant economy. This situation will have to be corrected before the new governmental structure is introduced.

Policy options and consequences

The government of Ukraine is planning a thorough reorganization of local governments. The plan is to consolidate current towns and townships into entities with populations of about 5,000 residents. This will represent a dramatic improvement over the current system, in which many authorities are far too small to be efficient or effective.

The key to the success of this plan is the effective decentralization or devolution of both responsibilities and financial and legal authority to lower levels of government. If decentralization is to be successful, local governments must be up to the task. They must have the human and financial capacity to do what they are asked to do. The IER (2004b, 2) says it well:

Using the advantages of fiscal decentralization requires:

- a. sufficient autonomy of local government entities (LGEs) from the center in determining the volume and structure of local budget expenditures,
- b. clear division of responsibilities across levels of sub-national government based on economic criteria,
- c. sufficient administrative and financial capacity of sub-national governments to fulfill assigned functions and finance expenditures,
- d. proper incentives and accountability mechanisms for LGEs ensuring efficient supply of public goods.

The proposed policy strategies in this section address these requirements.

Aggressive anticorruption programs

Transparency International provides a number of suggested steps that governments can take to reduce corruption (Transparency International 2005). These will not be repeated here, but it is clear that those in a position to benefit from corrupt activities must be given ample incentives to behave ethically. Some of the strategies known to work include privatization, streamlining of government procedures, improved accountability, improved economic incentives for public officials, and a strong civil society.

Privatization. The public sector has a logical and justifiable role in providing services that cannot be provided efficiently by the private sector, either because there is insufficient incentive for the private sector to provide the service, because there is insufficient competition to assure competitive pricing, or because the sector cannot be regulated. However, public ownership provides an opportunity, and usually a financial incentive, to commingle public and private interests. By privatizing all activities that can reasonably be operated by the private sector, competition is introduced and the opportunities for corruption are reduced.

In addition, the government of Ukraine should consider outsourcing as many local and regional public sector activities as feasible. Such public activities as accounting, legal work, and information technology could all be outsourced. The advantages of

outsourcing go beyond the potential for reducing corruption. Outsourcing would let firms provide services to several governments simultaneously, thus allowing them to find the optimum scale of operation. It would introduce competition into the provision of services, stimulating innovation and cost-saving practices.

Moreover, outsourcing would reward firms with ethical employees, since such firms would earn higher profits than competitors whose employees expected bribes and kickbacks. More profitable and competitive firms would have an incentive to reward their employees in turn, thus creating incentives for ethical behavior that are more difficult for noncompetitive government agencies to offer. Outsourcing would also make it easier to terminate the services of corrupt workers and place the onus of enforcement more onto owners of the firms. There could still be opportunities for kickbacks in the contracting process, but a well-designed open tendering process would be easier to police than thousands of transactions with the public.

Streamlined government procedures. Regulations provide additional opportunities for corruption. The more points of regulatory intervention, the more opportunities there are for agents to extract undeserved benefits from the process. Furthermore, each intervention point also increases transaction costs, which reduces efficiency. An efficient regulatory institution will impose only requirements that are absolutely necessary. Furthermore, it will set up these requirements so that they can be fulfilled in as few steps as possible and in the least costly fashion (see chapter 7 on agricultural regulation for examples of regulatory reform in other countries). Finally, there should be no duplication of requirements by multiple agencies. To meet most regulatory requirements, applicants should only have to appear or submit forms once, and then should only have to complete a simplified application. One-stop shops should be made available for as many types of regulatory approval as possible.

Improved accountability. Accountability is an area of public policy where Ukraine could “leapfrog” other countries. Information is the key to accountability, and information and communication technology can make timely, inexpensive information readily available to a maximum number of people. Ukraine should make e-governance² one of its top priorities. While it is true that governments can communicate electronically only with those who have access to communication technology, this doesn’t preclude communicating in other ways as well. Besides, if development of community information centers (see chapter 4 on rural development policy) is made a key element in Ukraine’s infrastructure priorities, then access will be available to most citizens. E-governance has proven its value in numerous developed and developing countries. Each country must develop the e-governance strategies that will work best under its specific circumstances.

2 “E-governance” employs information and communication technology, especially the internet, to enhance public participation in the policymaking process, increase accountability of government employees, reduce the cost of providing public services, and improve communication between government administrators, government employees, and residents.

es. In Ukraine's case, the lack of investment in traditional governance infrastructure and the absence of ingrained democratic traditions will make it easier for the country to develop an innovative governance system.

Improved incentives for public officials. None of the changes above will be successful unless incentives facing public officials are changed. Regulations give rights and bargaining power to the regulatory power. In a well-designed and properly operating institution, these rights belong to citizens and consumers, not to public officials. The officials should be rewarded for doing their jobs in an efficient and ethical fashion. Pay rates should be comparable to those for private sector positions with similar responsibilities. Continuation in their jobs should be conditional on ethical and efficient behavior. If public employees violate the trust placed in them, then they should lose their jobs. A careful and open review procedure should be instated to protect public employees from losing their jobs unfairly, but at the same time protect the public from corruption.

Strong civil society³ organizations. Strong civil society is much more than a means of combating corruption, but USAID (Rosser 2000, 11) finds that it is an important factor in this process:

We believe that a successful, long-term sustainable strategy to break the cycle of systemic corruption must include mobilizing pressure from a broad base of society. By providing training and other forms of support, USAID encourages the growth of active, public policy-oriented civil society groups that will monitor governmental integrity, bring corruption issues onto the public agenda, and actively promote the twin concepts of transparency and accountability.

Local tax reform

Efficient and effective local and regional governments require stable, robust sources of revenue. It is important that a government's tax base grow at least as fast as demand for services. In addition to ensuring robust public sector revenues, growing tax bases are almost always a sign of a strong economy and are desirable outcomes themselves. Thus it is important that public administrators be rewarded (personally as well as professionally) for improving the local and regional tax bases, and concomitantly their regional economies. At a personal level, annual pay raises should reflect the success of public administrators in achieving specified goals. At a professional level, growing tax

3 The London School of Economics defines "civil society" as "the arena of uncoerced collective action around shared interests, purposes and values. In theory, its institutional forms are distinct from those of the state, family and market, though in practice, the boundaries between state, civil society, family and market are often complex, blurred and negotiated. Civil society commonly embraces a diversity of spaces, actors and institutional forms, varying in their degree of formality, autonomy and power. Civil societies are often populated by organisations such as registered charities, development non-governmental organisations, community groups, women's organisations, faith-based organisations, professional associations, trades unions, self-help groups, social movements, business associations, coalitions and advocacy groups." http://encyclopedia.laborlawtalk.com/Civil_society

bases will make their jobs easier. For this to happen there must be a close association between the decisions made by local policymakers and the growth in their jurisdiction's tax base (value added, sales, land, property, etc.).

The IER (2004a) has assessed the revenue challenges facing Ukraine's local governments. This research indicates that local governments are becoming more dependent on the central government and thus have little incentive to expand their tax bases. It also shows that local governments' own-source revenue is not growing, which will make it difficult for them to function.

A reorganization of local and regional governments will make it imperative that these issues be addressed. Some of the strategies that should be considered include broadening the tax base by eliminating all or most tax exemptions; a shift in types of taxes toward taxes with bases that will be affected the least (i.e., tax bases with low tax-rate elasticity); reallocation of tax authority to increase coincidence between benefits and costs of the tax; and a shift to user fees.

As a general rule, subsidies should be reserved for those activities that are considered meritorious and underprovided, while extraordinary taxes should be applied to activities that are considered deleterious and/or overproduced. Within these guidelines, there are many opportunities to simplify, flatten, broaden, and lower taxes and tax rates.

Elimination of tax exemptions. It should be kept in mind that tax exemptions are really subsidies. As such, they redistribute income among buyers, sellers, and taxpayers, as well as cause economic distortions by leading taxpayers to shift their investments to the exempted activity or sector. Thus tax exemptions should not be used to augment income or offset price changes. They should be used only when it is considered in the public interest to increase the level of a particular activity or sector.

The overriding principle here should be to tax as much of the tax base as possible so that the tax rate can be as low as possible. Value-added taxes, land taxes, property taxes, and most other taxes should apply to most, if not all, subcategories of the tax base. Broadening the tax base generally increases the fairness of taxes as well.

An additional reason not to exempt a particular sector from taxes is that it reduces the local policymakers' incentive to support the sector with public services, infrastructure, and other programs. Thus, exemptions that were intended to aid specific sectors may very well have the opposite effect—they may reduce the sectors' income and competitiveness by starving them of public services. In chapter 6 we make the case that agriculture must contribute to local tax revenues so that needed public services and infrastructure can be provided. Tax privileges for agriculture not only distort farmers' incentive systems, reducing their overall efficiency, but also reduce government investment in agriculture-related infrastructure and services.

Increased use of land tax by local governments. Land is an immobile investment. Land taxes cannot induce owners to relocate their asset elsewhere, as do taxes

on machinery, buildings, and other so-called fixed assets. Furthermore, in the long run taxes on land do not affect income, profits, or competitiveness. Higher land taxes are calculated into the value of land, leaving future buyers of the land unaffected financially. Changes in taxes do affect current landowners, which is why it would be desirable to reform land taxes now, before sales of agricultural land are allowed.

In general, land taxes should make up a significant portion of government revenues. In addition to having low elasticity, land taxes are more stable than other taxes, are less distorting, and are relatively progressive; moreover, the benefits of local and regional government programs correspond quite closely to the level of taxes collected. Thus while taxes on land tend to reduce its value, public investments in infrastructure, economic development, planning, and other local programs tend to increase land values and hence land taxes. Good government will provide public services that are worth more than their cost in taxes and have a net positive impact on profitability, land values, and economic development.

Another advantage of taxing all land is that taxes on land induce its owners to make the highest-value use of it. Idle and underused land should be taxed at its market value, which, in a functioning land market, will reflect its potential and not its actual use. Taxing land at this market value will encourage landowners to put it to its optimal use (i.e., the use that has determined the land's price), since lower-value uses will lead to lost income.

Increased reliance on the value-added tax for local governments. The value-added tax, when applied broadly and fairly, taxes gross domestic product, the broadest indicator of the size of the economy. Economic growth leads to growth in tax revenues. Thus local policymakers have an incentive to invest in those types of infrastructure, public services, and programs that lead to economic growth.

Greater use of user fees to finance public services. When feasible, there are a number of advantages to directly charging users for consumption of public services. It is true that many public services can only be funded from general tax revenues because the user of the service cannot be easily determined (such as police services) or because fees cannot be efficiently collected (low-volume roads). Other public services such as public education are deemed to be so important that they are left free to the user to encourage their consumption. Still other services (such as market information) cost nothing or very little to provide to additional users and should not bear a fee. But the remaining services, such as extension, adult education, soil testing, public transportation, and mail delivery can all be subject to user fees that cover part or all of their costs.

Several caveats must be mentioned. The first is that some services should not be provided publicly at all. The first question that should be asked is, "Can this service be privatized, leaving it to private firms to set prices and charge fees and creating the possibility of competition and greater innovation?" If the answer to the first question is no (possibly because it would lead to a monopoly), the second question should be, "Can

this service be outsourced so that a contractor provides the service at a negotiated user fee?” Finally, if the answer to the second question is no (perhaps because the private sector is unlikely to invest in the infrastructure), then the public sector should provide the service directly. The final question is whether the service should bear a user fee or not. These questions are summarized in table 5.1.

A second caveat is that there must be a sound anticorruption mechanism in place. Charging users a fee for service without proper accountability and safeguards will only perpetuate corruption.

Reorganization of local government entities

Co-operation between communities and the setting up of horizontal partnerships between public and private actors over areas sufficiently large to define coherent, common strategies have been seen as the most effective means by which to take into account these new forms of territorial development. These flexible forms of governance permit governments to better exploit local complementarities and, notably, to ensure continuity in infrastructural development through the sharing of public investments. —*OECD 2003, 22*

Table 5.1: A guide to optimal means of providing services to the public, based on the services' characteristics

Nature of the service	How the service should be provided	Possible examples
This service can be privatized	Private sector sells service directly to consumers	Agricultural management consulting, adult education
Service cannot be privatized but can be outsourced with a user fee	Private sector bids for contract with the state to provide service, charges a user fee	Postal service, public transportation, public parks
Service cannot be privatized and it cannot bear a user fee	Private sector bids for a contract to provide service at a contracted rate paid from general revenues	Public education, road maintenance
Service cannot be outsourced but the state can charge a user's fee	Public sector determines and charges a user fee at or below cost of provision	Certain types of extension services
Service cannot bear a user's fee	Public sector provides service and funds it from general revenues	Social services, general administration

Opportunities to reorganize governments are rare. As stronger local governments emerge from this period of transition, they will probably resist future changes. So it is important both to make these changes as future-oriented as possible and to build in as much flexibility as possible to permit change in the future. The population, and settlement pattern, of rural Ukraine is going to change dramatically over the next generation, and the local government structure must be built to accommodate these changes.

No matter how successful rural development programs are over the next generation, some rural areas—those with the weakest economies—are going to lose population. These migrants will relocate in more prosperous rural and urban regions. Thus a system that starts out with an average of 5,000 residents in each local jurisdiction will become one with far fewer residents in some and far more in others. Furthermore, the pattern of functional economies will change as economic bases change. Some communities will become more closely linked to others, and their interests will shift from one center to another. Thus a provision for redistricting may have significant value.

The ideal way for the boundaries of local governments to be determined would be for their residents to decide among themselves. With sufficient information and a sound decisionmaking process, local people will know best who shares their local interests and what areas are included in their functional regional economy. This bottom-up approach may not be possible during the initial reorganization because information will be scarce and economic relationships will be in a state of rapid change, but subsequent jurisdictional changes should proceed according to the will of residents. As the OECD (2003, 22) summarizes:

Municipalities co-operate with each other because they see that they cannot resolve their social and economic problems on their own. They tend to cluster around a lead municipality and often share a sense of belonging to a common identity. Often central or supra-national governments encourage partnerships through a system of incentives and an accompanying legislative framework (France, Italy, Mexico, European Union initiative LEADER, etc.).

A low-cost procedure for redistricting would be ideal, with incentives built in to redistrict when appropriate.

Increased capacity of rural governments

The dramatic changes in governance planned by the government of Ukraine will require a significant increase in the capacity of local leaders to make decisions, manage resources, and instill confidence in their constituents. There is evidence that the capacity at the local levels is already lacking. For example, the TACIS report on reorganization of the Ministry of Agricultural Policy notes that “again and again during this analysis, it was shown that the capacity of the regional agriculture administrations

(especially at the rayon level) is relatively low” (Jannermann 2004, 36). This view is echoed in a recent study by the IER (2004b, 1), which found “low administrative and fiscal capacities of local government entities (LGEs), resulting in poor incentives and low accountability of local governments for execution of their tasks.”

A number of approaches should be considered as means of increasing the capacity of local governments and administrations. Particularly notable are public administration education programs, e-government, and promotion of civil society.

Public administration education programs. Educational programs for local elected officials and for public administrators should be offered on a regular and continuing basis. The programs should be outsourced and competitively developed. It is expected that some programs would be developed by private sector providers while others would be offered by institutions of higher education and not-for-profits. The state’s role would be in accrediting programs and determining if minimum educational requirements are necessary for various public administration positions.

E-government. Information and communication technology should be exploited at all levels of government. All local governments should have broadband connectivity and training in the use of the technology. All public information should be openly available on the web.

Technology is one of the keys to transparency in government. USAID has found that the internet can be used to inform the public and to allow anticorruption groups to network and work more effectively. Technology should also be used to support public administrators. Periodical training and updates should be made available from the central government to local and regional governments.

It may seem like too big a step for a country with little broadband infrastructure, and one in the process of transforming its public sector, to look to e-governance as a primary strategy. But on the contrary, for Ukraine this is just the right thing to do, because there are so few vested interests in the status quo. Ukraine has an opportunity to simultaneously develop its e-business, e-governance, and e-communities by ensuring that the infrastructure is there and encouraging its use. While the cost of such a bold strategy may be high, it will save the costs of investing in outdated approaches and then trying to catch up.

Promotion of civil society. It is well established that a strong and active civil society is a critical element in anticorruption efforts. As Rosser’s study of USAID’s anticorruption experiences emphasizes (2000, 1), “We are convinced that civil society can have a significant effect on a government’s will to enact and sustain anti-corruption reforms,” adding (*ibid.*, 3) that “civil society engagement is an important factor in sustaining reforms.” A strong civil society will increase the rate of transformation in the economies and public administrations of rural areas. Civil society is thus an important element in the networks that support successful entrepreneurs as well as good governance.

Concluding remarks

Ukraine has embarked on an ambitious program of local and regional government reorganization. This is a highly desirable course from the perspective of both agricultural and rural economic development. However, development of an effective and efficient system of governance is a complicated undertaking in a country without a recent tradition of open governance. It will require patience and investment.

The most significant needed departures from current governance policy identified in this chapter are

- an aggressive anticorruption policy. This policy will be built on a new standard of ethics, a new civil society, and new institutions. It will require a substantial revision of incentive systems and the use of information technology.
- reorganization of local governments. This reorganization will complement the anticorruption policy but will primarily be concerned with supporting an efficient private sector by creating an efficient public sector. It will feature fundamental changes in the way that public revenues are generated, including the elimination of most tax privileges and exemptions and a greater reliance on land taxes.

Ukraine's local governments must become a part of the recovery of the agricultural and rural economies. This will require a reinvention of local governance. The consequences of this new form of governance will be a vast improvement in public services, a more equitable and less distorting system of taxation, a rebirth of civil society, and rising prosperity.

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CHAPTER 6

Rationalizing Agricultural Taxation

Sergiy I. Zorya

EXECUTIVE SUMMARY

In any economy, fiscal resources are needed to execute state functions. It has been said that what government gives it must first take away. In the market economy, the state is responsible for provision of public goods. In Ukraine historically, collective farms provided most public goods in rural areas. These farms received very large budget and other support, and they were responsible for developing and maintaining the social infrastructure, as well as conducting nonfarm activities such as construction, retailing, road building, electrification, water supply, and other services. In the course of transition, reformed agricultural enterprises were theoretically freed from taking responsibility for rural development. But since village councils do not have adequate financing, the agricultural enterprises continue to be expected to provide all the services to the village they provided in the past.

The agricultural sector in Ukraine enjoys significant tax exemptions and privileges. In 2004, total tax privileges were UAH3 billion, including benefits from the fixed agricultural tax, exemptions from VAT on sales of agricultural products, and VAT returns to milk and meat producers. The major reason for such benefits is to substitute for low direct budget support. In 2004, direct budget subsidies were also UAH3 billion. In addition to the FAT and VAT, in 2005 agricultural producers began paying contributions to the social and pension funds, but at rates below general rates. In 2006, the special VAT regime will come into force.

Agricultural development plays an important role in rural development, but the rural economy is much more than agriculture, and its development is highly dependent on public investments in rural infrastructure to make rural areas more suitable for nonfarm activities. Agriculture must contribute to rural development by paying more taxes, which will enable local governments to effectively fulfill their duties.

The first positive sign that agricultural taxation is changing to approximate general taxation rules is the exclusion of social and pension contributions from the FAT. We support the gradual increase of the social contribution rates. Since the Ukrainian government plans to reduce payroll taxes in the future, a return to general taxation rules will be less painful. Due to its simplicity and transparency, the FAT should remain, but its rates must be gradually increased. Currently, the taxation of small subsistence producers should not be significantly changed; however, over time it should transition to the simplified taxation applied to other rural entrepreneurs.

VAT privileges make up the biggest portion of agricultural tax benefits, but due to their negative sectoral and macroeconomic effects, these privileges must be abolished. We do not support the introduction of special VAT rates for agricultural products, because they will not significantly increase agricultural incomes; rather, they will increase the complexity of farm accounting. Agricultural income depends not only on the purchasing power of consumers, but also on the efficiency of product and factor markets, as well as agricultural policy. VAT rates should be reduced for all products, and VAT rates for agricultural products should equal the general rates.

The government should not forget that agriculture is heavily subsidized by direct subsidies and tax exemptions.¹ Farmers slowly became accustomed to low taxes and now take them for granted. The government continuously repeats the message that current tax privileges will last for only a short period of time, but unless it supports these words with actions, all serious tax reform will be heavily opposed by farmers—indeed, many already see the tax exemptions as a natural right.

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Introduction

In any economy, fiscal resources are needed to execute state functions. It has been said that what government gives it must first take away. In 1936, U.S. President Franklin Delano Roosevelt said “Taxes, after all, are the dues that we pay for the privileges of membership in an organized society.” Government can raise its income through different sources, but taxation is the most sustainable method of transferring resources from the private to public sector.²

In market economies, the market mechanism is able to supply goods and services efficiently (Adam Smith’s metaphor of the “invisible hand”). But sometimes the market itself is not able to produce the most efficient outcome. In such cases, the state may be able to correct or improve the market mechanism. In relation to agriculture, the state may create and empower antimonopoly legislation, tax producers of negative externalities and support producers of positive externalities, and provide public goods. To do these things, the state generally requires revenue.

Historically, collective farms provided most of the public goods in rural areas. The farms received very large budget and other support³ and were responsible for developing and maintaining the social infrastructure as well as conducting nonfarm activities such as construction, retailing, road building, electrification, provision of water, and other services. In the course of transition, reformed agricultural enterprises were relieved of their responsibility for rural development. Several legislative acts ordered the transfer of the social assets to the balance of village councils,⁴ and now most agri-

1 See chapter 2 on reforming agricultural support.

2 Other sources are money creation, charges for the use of public goods and borrowing. These sources, however, either encourage inflation or are non-sustainable since there are limits to how much people are prepared to lend, even to government.

3 See Chapter 2 on reforming agricultural support in Ukraine.

4 Law of Ukraine “On the transfer of state and communally owned facilities” from March 3, 1998, and Presidential Decree “On certain measures aimed at improving conditions for non-state agricultural enterprise activities” dated March 9, 2000.

cultural enterprises do not have any construction or other crews. But since the village councils do not have adequate financing, the agricultural enterprises continue to be expected to provide all the services to the village they typically provided in the past.

Instead of taxing agricultural producers at the same rate as commercial entities to collect revenues needed for rural development activities, the state provides generous tax privileges to small and large farms in recognition of agriculture's special role as a driving force of rural development. This chapter suggests a strategy of rationalizing and modernizing agricultural taxation. Agricultural enterprises must contribute more to the budget to enable local authorities to take responsibility for social assets and stimulate rural nonfarm activities.⁵ At the same time, agricultural producers must not be taxed at higher rates than other groups of producers. The following section of this paper summarizes the goals of taxation. This is followed by a review of the current agricultural taxation in Ukraine. The next section reviews the impact of agricultural taxation on agriculture itself, the rural economy, and then the rest of the economy. The paper closes by presenting policy options and their consequences.

Goals of taxation⁶

A good tax system in a market economy is based on the following principles:

- **Economic efficiency:** Taxes should be chosen so as to minimize interference with economic decisionmaking, because such interference imposes efficiency losses. The preferential treatment of certain goods and services or sectors induces overall inefficiencies through distorted production and consumption decisions.
- **Economic growth:** Taxes should foster economic growth through savings and investment. The tax structure should facilitate the use of fiscal policy for stabilization and growth objectives. Moreover, it should ensure a stable and optimal supply of public revenues for financing the supply of public goods.
- **Fairness:** The distribution of the tax burden should be equitable. Everyone should pay his fair share: people with equal capacity should pay the same tax (horizontal equity), and people with greater ability to pay more tax (vertical equity). A system that is not fair or allows arbitrary tax breaks loses respect and reduces willingness to comply.
- **Low compliance and administrative costs:** If the incidental costs of complying with the requirements of the tax laws and procedures are high, there will be a greater tendency to evade. In addition, administrative costs should be low enough to ensure adequate revenue. The tax system should employ procedures that are cost effective.

5 See Chapter 4 on stimulating rural development and Chapter 5 on decentralizing government administration in Ukraine.

6 This section is based on Demyanenko and Zorya (2004). See also Chapter 5 on decentralizing local governments, which also presents the goals of taxation.

- **Simplicity and stability:** If tax revenues are not stable over time, the state budget and programs will be affected. Often changes in rates, rules, and exemptions make it difficult for the private sector to make long-term investment plans. Taxes then become a significant source of risk.

Based on these principles, the important task of the government in a transition economy such as Ukraine's is to adjust its tax system to accelerate the transition from planned to market economy and to ensure the system's long-run sustainability. The tax system should encourage markets by stimulating private production through tax neutrality across sectors and across the public and private spheres. In the new market environment, the state has to take upon itself many functions previously assumed by large enterprises. Hence, the tax system has to ensure stable and sufficient budget income to allow the state to fulfill its obligations.

To solve the specific problems of the transition economy, the new tax system must aim to reduce specific distortions such as payment arrears, barter, and corruption. Economic agents in the Soviet Union were allowed not to pay taxes. Thus, to encourage the firms and individuals to pay taxes in the market environment, a comprehensive approach should be taken to change this behavior.

Review of current agricultural taxation in Ukraine

Currently, agricultural producers in Ukraine are granted numerous tax exemptions and privileges, but their nonagricultural activities are taxed under the general taxation rules. The major features of taxation of small and large agricultural producers are described below.

Fixed agricultural tax

In 1999, the Verkhovna Rada (parliament) introduced the fixed agricultural tax (FAT), which replaced 12 taxes previously paid by farms.⁷ The FAT lowered the tax burden on farms and simplified tax calculation and collection. After the recent changes to the pension and social insurance legislation, starting from 2005 the FAT revenues go exclusively to local budgets.

Farms of different organizational and legal forms are eligible to pay the FAT, provided that they are involved in agricultural production and agricultural products account for over 75 percent of their revenues. The base of the FAT is the value of a farm's agricultural land as determined on July 1, 1997. Land value is determined according to its quality and potential productivity. The average land value in Ukraine for FAT purposes 8,733 UAH/ha, ranging from a maximum of 11,297 UAH/ha in Cherkasy to a minimum of 6,244 UAH/ha in Zhytomyr (excluding Kiev, Sevastopol, and Crimea). The tax rates are specified for two types of agricultural land: 0.15 percent of the value of arable

⁷ The most important of these were land, profit, automobile, and individual income tax; and payments to the pension, social security, and unemployment funds. See Law of Ukraine, "On Fixed Agricultural Tax," December 17, 1998.

land, haying, and pastures; and 0.09 percent of the value of land in perennial crops.⁸ Tax calculations have to be submitted to the rayon (district) tax administration by February 1 of the corresponding year. FAT is paid monthly, but the payment takes into account the seasonality of agricultural production, so that 10 percent of the total payment is due in the first and second quarters, while 50 and 30 percent are due in the third and fourth quarters, respectively.

In 1999, the farms paid UAH173 million of the FAT, and in 2004 FAT payments grew to UAH450 million. According to the Ministry of Agricultural Policy, the annual value of the FAT exemption is estimated to be UAH1.4 billion (Demyanchuk and Seperovych 2005; World Bank and OECD 2004). However, this estimate is suspect, because the privileges due to FAT exemptions should grow at least as fast as the growth of gross wages. During 2000–04, the agricultural wages increased threefold, but this is not taken into account in the tax privilege estimation.

Value added tax

Agricultural enterprises in Ukraine benefit from special provisions concerning the accrual and payment of the VAT. First, since 1999 farms have been exempt from paying VAT to the national budget. The accumulated VAT received from sales was instead deposited into special bank accounts and used only to purchase agricultural production inputs. In 2004 the VAT tax exemption was UAH1.2 billion (table 6.1). However, farms continued paying the VAT for nonagricultural products and services (table 6.2).

Second, producers of milk and meat charge no VAT when they sell their products. Moreover, 70 percent of the VAT received by processing plants when they sell milk and meat products is given to the farms, while the Ministry of Agricultural Policy accumulates another 30 percent to finance livestock breeding. In 2004, the VAT returned to milk and meat producers was UAH400 million (table 6.1). However, there are indications that some food processors fail to return VAT to small milk and meat producers (Demyanchuk and Seperovych 2005).

In 2005, the VAT for the agricultural producers is similar to that in 2004, but in 2006 the special VAT regime for agricultural producers will be introduced.⁹ The agricultural producers will choose whether to participate in the special VAT regime or remain in the general taxation system. The feature of the special VAT regime is that the VAT on sales of agricultural products is set at 10 percent during 2006 and 2007, and then reduced to 9 percent. The accumulated VAT will remain in the bank accounts of agricultural producers, but when incoming VAT is higher than outgoing, the state will not compensate the difference to the farms. The reduction of the VAT rate for the sales of agricultural products is expected to stimulate domestic demand for agricultural products.¹⁰

8 Until 2004, the tax rates were 0.5 percent and 0.3 percent respectively.

9 The law of Ukraine "On Making Amendments to the Law of Ukraine on the Value-Added Tax," June 24, 2004.

10 See Demyanchuk and Seperovych (2005).

Contributions to pension and social funds

During 1999–2004, contributions to the social and pension funds of agricultural enterprises were incorporated into the FAT. Sixty-eight percent of FAT payments were directed to the state pension fund, and 2 percent were allocated to the state social insurance fund. Starting in 2005, these contributions were excluded from the FAT, and agricultural enterprises had to contribute based on actual wages paid.¹¹ Rates, however, in 2005 were only 20 percent of the general contribution rates. In 2005, farmers will allocate only 6.4 percent (rather than 32 percent) of gross wages to the state pension fund. In 2006 this rate will increase to 40 percent, and in 2010 the agricultural enterprises will make the social contributions under general rules. In 2005 the state budget foresees expenditures of UAH1.2 billion to compensate for the lower incomes of the state pension and social funds due to privileged rates for farmers.

Taxation of subsistence farms

Small subsistence households pay land and personal income taxes but are exempt from the VAT, as well as from income tax on sales of agricultural products produced by their household farm. Personal income is taxed at a flat 13 percent rate, and the average land tax is 50 UAH/ha (Demyanchuk and Seperovych 2005). The actual tax burden per hectare of agricultural land of these small farms seems to be larger than those of large agricultural enterprises, which pay the FAT.

The tax burden on large agricultural enterprises in Ukraine

Based on World Bank and OECD data (2004), agricultural enterprises in Ukraine paid UAH3.065 billion in 1998, UAH1.459 billion in 1999, UAH0.798 billion in 2000, and UAH1.887 billion in 2001 (table 6.2). We do not have detailed data for recent years. Based on table 6.2, we can calculate the tax burden as the ratio of taxes paid to the gross agricultural output (GAO) of large agricultural enterprises. In 1998, the tax burden was 12.7 percent, in 1999 it fell to only 6.7 percent, and in 2000 it dropped even further to 3.8 percent. In 2001, however, the tax burden grew to 7.4 percent. In 2000 and 2001, agricultural enterprises on average paid 52 UAH/ha of agricultural land, or almost half the amount paid in 1998.

The true tax burden of agricultural enterprises, however, was even lower than estimated above. In 2001, for example, VAT for nonagricultural products and services accounted for 72 percent of all taxes paid. If these are deducted from the gross taxes paid by agricultural enterprises, the tax burden decreases from 3.8 to 1.7 percent in 2000 and from 7.4 to 2.1 percent in 2001. Finally, if farm enterprises had not been granted any exemptions in 1999, their tax burden would have increased to 16 percent. Analogous figures for 2000 and 2001 are 13.4 and 18.1 percent, respectively (table 6.2).

11 Starting in 2005, the FAT incorporates only five taxes: profit tax, land tax, communal tax, fees for geological work, and special use of natural resources.

Table 6.1: Tax exemptions and privileges of Ukraine's agriculture, UAH millions, 2001–04

	2001	2002	2003	2004
Benefits from fixed agricultural tax	1,400	1,365	1,400	1,400
Exemptions from VAT sales of agricultural products	541	1,457	1,470	1,240
VAT returned to milk and meat producers	634	671	357	400
Totals	2,575	3,493	3,227	3,040

Source: World Bank and OECD (2004); IER (2005).

Table 6.2: Tax burden of agricultural enterprises in Ukraine, 1998–2001

	1998	1999	2000	2001
1) Taxes paid by agricultural enterprises, UAH millions	3,065.0	1,459.0	798.0	1,887.0
2) Taxes paid from nonagricultural activities, UAH millions	na	na	429.0	1,353.0
3) Taxes paid and tax privileges, UAH millions	3,272.0	3,514.0	2,837.0	4,585.0
4) GAO of agric. enterprises, UAH millions	24,081.0	21,930.0	21,151.0	25,352.0
5) Actual farm tax burden, % [1/4]	12.7	6.7	3.8	7.4
6) Tax burden from agricultural activities, % [(1–2)/4]	na	na	1.7	2.1
7) Assessed tax burden without tax privileges, % [3/4]	13.6	16	13.4	18.1

Source: Demyanenko and Zorya (2004).

Effects of agricultural taxation

Privileged agricultural taxation not only stimulates agricultural production and increases farm worker wages, but it also has important visible and invisible effects on agriculture itself, rural development, and the rest of the economy. These effects are described below.

Agricultural sector¹²

In Ukraine, the experiment with the FAT and the VAT privileges is considered by many agricultural policymakers to be very successful. While the VAT privileges represent pure subsidies to agriculture, the FAT brings special advantages. First of all, the FAT is relatively simple to calculate if land areas, land values, and tax rates are known. Given the complexity of the tax system in Ukraine, the simplification of the farm tax system that resulted from the introduction of the FAT represents a major improvement. Simplicity reduces the costs of tax calculations and allows farmers to make long-term plans. It also reduces ambiguities in the tax system, which is important because ambiguity gives tax and local authorities discretionary power that in the past has often been used to interfere in farm management. Second, the FAT does not require farms to carry out complex tax accounting. Whether this is an advantage or not is debatable: on the one hand it reduces costs for farms; on the other hand, farms do need good accounting systems if they are to make good decisions and gain access to credit. In the long run, especially the large farms in Ukraine should be expected to keep books according to international standards. Third, some defenders of the FAT say it raises the efficiency of land use, as it places a larger burden on less efficient land users and puts more efficient users in a position to offer higher rental payments on the market for leased land. In principle this is true, but the key is the tax rate that the land user has to pay. If this rate is low, the advantage that the FAT conveys to efficient land users will be small, and the FAT will probably have little practical impact on efficiency of land use.

These positive effects, however, are countervailed by several negative effects. First, the success of agricultural development hinges, among other things, on the provision of public goods such as research, education, extension, social services, and infrastructure. In Ukraine, investments that can provide such goods are desperately needed to close the productivity gap between farming at home and in the rest of the world, and to increase standards of living in rural areas. FAT and VAT exemptions for agriculture reduce the ability of the state to invest in these public goods. The result is a loss of agricultural competitiveness in the long run. Furthermore, large farms are often obliged to continue providing some of these goods (the so-called “social sphere”), which constrains resources and further reduces their competitiveness.

Second, the FAT is biased against crop producers. It is true that livestock producers often utilize pastures and/or cultivate arable land to produce feed crops. Nevertheless, the tax burden per unit of cost, revenue, or profit will be higher for crop producers than for livestock producers. Some livestock producers with next to no land (e.g., an intensive poultry or pig operation) will pay almost no FAT. On average, livestock production in Ukraine is unprofitable, so policymakers often claim that it requires state support. This might be seen as justifying the favorable treatment it receives under the FAT. However, what is true on average need not be true in every

12 This section is based on Demyanenko and Zorya (2004).

case, and some livestock producers are obviously getting off very easy under the current system.

Third, since the tax exemptions substitute for the lack of direct budget financing—and thus the tax burden on agricultural producers in Ukraine is very low (table 6.2)—inefficient farms are retained. In addition to the low tax burden, there is no effective farm bankruptcy procedure. As a result, bad farm managers continue managing large farms and apply political pressure to convince the government to assist “poor” farmers. Moreover, large farms continue to cross-subsidize the small subsistence households that hamper the commercialization and competitiveness of agriculture in Ukraine.

Rural development

The privileged farm taxation has some positive effects on the rural economy. Some share of higher incomes from agricultural activities is spent in the rural areas, and the nonfarm activities benefit from these spillovers. Moreover, the lower tax burden increases the ability of agricultural land lessees to make higher land-lease payments to rural dwellers. However, these benefits are static and are diminishing over time.

The largest negative effect of the privileged agricultural taxation is the weakening of the tax base for local and central budgets.¹³ As a result, the state obtains less budget income to finance rural development and ensure the real transfer of the rural social sphere to the budget and responsibility of village councils.¹⁴

Rest of the economy

Farming does not occur in isolation from other economic activities. The farm tax system affects macroeconomic development in a country through a number of channels, most of which are invisible. Often agriculture becomes hostage to these invisible effects, because macroeconomic destabilization also affects farms. Surely, privileged agricultural taxation also has positive effects on the rest of the economy, at least in the short run. It allows farmers to contribute more to the GDP and reduces rural unemployment by keeping more labor on the large farms. However, the duration of these positive effects is probably very short term, because farm support in Ukraine reduces farm efficiency, and thus the long-term agricultural contributions to the GDP. Furthermore, more jobs in protected agriculture means less jobs in other sectors of the economy.

Farm taxes have a direct impact on the state budget and thus on overall economic development in Ukraine (table 6.3). Total farm tax privileges are large, amounting to an average 1.3 percent of GDP over 2002–04. Under the existing tax system, farm taxes account for about 2.1 percent of the total budget incomes. Budget revenue would, how-

13 For more detail, see chapter 5.

14 This issue is addressed in chapters 4 and 5.

Table 6.3: The farm tax system and the state budget in Ukraine, 2002–04

	2002	2003	2004
Farm taxes paid, UAH millions	1,672.0	1,287.0	1,750.0
Total farm tax privileges, UAH millions	3,493.0	3,227.0	3,040.0
Farm tax privileges as a share of GDP, %	1.6	1.2	0.9
Share of agriculture in total GDP, %	13.0	11.0	12.5
Share of farm taxes in total government revenue, %	2.7	1.7	1.9
Share of farm tax privileges in total government revenue, %	5.6	4.3	3.3
Budget balance as a share of GDP, %	−0.7	−0.2	−3.4
Budget balance as a share of GDP without farm tax exemptions, %	0.9	1.0	−2.5

Source: Own calculations based on table 6.1 and NBU (2005).

ever, be 4.4 percent higher if tax privileges for agriculture were eliminated. In this case, the budget would have been in surplus rather than in deficit in 2002 and 2003.

The indirect impact of farm taxation is felt through an increased tax burden on other sectors of the economy and reduced export competitiveness. Generally, the higher the tax privileges granted to agriculture, the higher the tax burden on other economic activities. Agricultural privileges are not free: they must be compensated for by increasing the tax burden on the “net payer” sectors.

The higher tax burden on other sectors of the economy is aggravated by increased incentives for resources to move to subsidized sectors, making them more expensive. As Leonard (2000) notes, “Agricultural tax privileges...create a strong incentive to retain agriculture as a fundamental feature of the production structure, even though market demand might require a shift into services or other kinds of production.” In the long run, higher taxes and more expensive inputs reduce the productivity and competitiveness of the “net payer” sectors, reducing budget income and overall economic growth. The problem of export competitiveness is exacerbated in Ukraine by the delays in refunding export VAT and the accumulated export VAT arrears of recent years. On June 1, 2005, the government’s export VAT arrears amounted to UAH3.5 billion. Total farm VAT exemptions between 2001 and 2004 amounted to UAH6.8 billion, which is twice higher than current export VAT arrears. Hence, it is reasonable to expect that if agriculture had been paying its fair share of VAT, the problem of export VAT arrears (essentially a tax on Ukrainian exports, including agricultural exports) could have been at least partly avoided.

Policy options and consequences

The agricultural sector in Ukraine has enjoyed significant tax exemptions and privileges. The major reason for such a privileged taxation system is to substitute for low direct budget support. While agricultural development does play an important role in rural development, the rural economy is much more than that; and its development is highly dependent on state investments in rural infrastructure to make rural areas more attractive for nonfarm activities. Agriculture must contribute to rural development, not through the maintenance of the social sphere, but rather through paying more taxes to enable government, especially local government, to effectively fulfill its duties.

The first positive sign that agricultural taxation is moving closer to the general taxation rules is the exclusion of social and pension contributions from the FAT. We support the idea of gradually increasing social contribution rates. Since the Ukrainian government plans to reduce payroll taxes, the return of agriculture to general taxation rules will be less painful. Due to its simplicity and transparency, the FAT should remain, but its rates must be gradually increased. Currently the taxation of small subsistence producers should not be significantly changed, but over time it should move closer to the simplified taxation rates imposed on other rural entrepreneurs.

The VAT privileges are the biggest ingredient of the agricultural tax benefits, and because of the negative sectoral and macroeconomic effects, these VAT privileges must be abolished. We do not support the introduction of special VAT rates for agricultural products, because this will not seriously increase the agricultural incomes. Instead, it will increase the complexity of accounting. Agricultural income depends not only on consumers' purchasing power, but also on the efficiency of product and factor markets, as well as agricultural policy. VAT rates should be reduced for all products, and VAT rates for agricultural products should equal the general rates.

Finally, we would like to stress one more time that the government should not forget that agriculture in Ukraine is heavily subsidized by direct subsidies and tax exemptions.¹⁵ Farmers slowly became accustomed to low taxes and now take them for granted. The government continuously repeats the message that current tax privileges are only for a short period, but unless it supports these words with actions, all serious tax reform will be heavily opposed. Indeed, many farmers already see the tax exemptions as a natural right.

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¹⁵ See chapter 2.

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Reforming Agricultural Regulatory Policy

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EXECUTIVE SUMMARY

Reforming regulatory policy for agriculture in Ukraine is a component of reform of the general state system of regulatory policy. Therefore, reform should be based on such general principles as expediency, adequacy, efficiency, fairness, predictability, transparency, and consideration of public opinion. In Ukraine, there is a sufficient legislative base for regulatory activity. Administrative and organizational measures are needed to allow state agencies, private businesses, and the public to collaborate to effectively implement them. Unfortunately, the principles and methods for implementing existing law are not executed in practice. Therefore, the public, and in particular the business sector, is dissatisfied with the existing regulatory system and expects it to be improved.

In recent years, steps have been taken toward reform of regulatory policy in Ukraine. The decree of the country's president, "On Some Measures on Providing Implementation of State Regulatory Policy," dated June 1, 2005, is the most recent step. However, aside from its positive purpose, this document contains contradictions. In particular, it conflicts with several of the principles of regulatory activity listed above and others defined by the laws of Ukraine.

Ukraine has had a negative experience with regulation of agricultural markets. State interference in the pricing and movement of products between regions and outside of Ukraine has inflicted considerable harm on market participants and, above all, producers of agricultural products. Examples are the regulatory actions of government imposed on the grain market in 2002–05 and on the meat market in 2005.

The introduction of quality standards for products, to satisfy the requirements of WTO accession conditions, will require additional investments from the state and private businesses. However, these need to be considered investments in market infrastructure that upgrade both product quality and food safety. The regulatory system in agriculture should not contain old national standards that conflict with new international standards. Taking into account the limited financial resources of Ukraine for the development of a food safety testing system, it is expedient to develop priorities for monitoring and controlling food quality and to concentrate on these priorities. Some countries have exactly such a strategy to develop technical and commercial standards for the separate prospective markets for food products.

The introduction and enforcement of international veterinary and phytosanitary standards of quality for agricultural products and foodstuffs contributes to economic growth, poverty reduction, creation of a favorable investment climate, and stimulation of collaboration between the state and private business.

In the system of sanitary and phytosanitary (SPS) control, product quality, and introduction of international standards, Ukraine must complete the needed organizational and legal measures, including the following:

- For certification of new seed varieties, Ukraine must liberalize procedures, shorten the testing time, and reduce the introduction cost of new varieties from domestic or foreign origin.
- For quality control for milk and milk products, Ukraine must introduce the index of quality for milk raw material based on the amount of somatic cells, and possibly the amount of bacteria per milliliter of product. Ukraine, as a member of the UN Food and Agriculture Organization (FAO), must strengthen connections and exchange of information with the International Dairy Federation (IDF) and the Codex Alimentarius Commission. Milk industry enterprises, both state and private, need to join these organizations.
- For harmonization of national legislation with WTO requirements related to SPS measures, existing law must be supplemented with regulations that will require basing national standards, technical regulations, and instructions and recommendations on norms set by the Codex Alimentarius Commission for food, by the FAO's Secretariat of the International Plant Protection Convention for plant health, and the International Animal Health Organization (Office International des Epizooties) for animal healthcare and prevention of zoonosis.¹
- Ukraine must take a position in relation to genetically modified organisms, the commercial use of which is becoming more widespread. Ukraine must base its decision on the need to supply high-quality foodstuffs to its citizens, the export market, and on the need to provide complete information on food quality.
- Policymakers must ensure that veterinary aspects of legislative acts relating to sanitary control and protection comply with international standards and rules.
- Ukraine should learn from the experiences of other WTO members with respect to the clear division of functions of state institutions and collaboration with private business in the regulatory sphere. Ukraine must also establish an institution that can serve as a single agency for implementation of norms and standards of food quality and safety, perhaps following the example set by other EU countries.

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¹ This concerns such laws of Ukraine as "On Ensuring Sanitary and Epidemic Safety of the Population," "On Quality and Safety of Foodstuffs and Raw Food Produce," "On Protection of the Population from Infectious Diseases," "On the Quarantine of Plants," "On Seed," "On Pesticides and Agrochemicals," "On Veterinary Medicine," "On Apiculture," and "On the Animal World."

Goals and essential characteristics of regulatory policy

For Ukraine to acquire a highly developed legal system and high standard of living demands modern regulatory policies. The goals of such policies are to eliminate economically disruptive and ineffective regulatory acts, reduce intervention from the state in private sector economic activities, and remove obstacles to the development of economic activities carried out in accordance with laws and procedures set by the Constitution and laws of Ukraine.² Reform of regulatory policy requires the transformation of the executive command principle that prevails in the current activities of public authorities in the regulation of economic relations. The reformed system would provide society with a stable, favorable, and transparent system regulating the economic activities of the private sector—without excessive cost or arbitrary interference.

The essence of a reformed regulatory policy takes account of society's interests and pays vigilant attention to basic economic improvement in general, and efficient use of state resources in particular. The public should take an active part in determining provisions of state regulation, from discussion of drafts of governmental decisions, to comprehensive consideration of comments and suggestions from all interested groups, to subsequent monitoring of the effectiveness of the decisions.

In accordance with existing law, regulatory policy in Ukraine is based on the principles of expediency, adequacy, efficiency, fairness, predictability, transparency, and consideration of public opinion. Policies are promulgated by regulatory authorities and by public officials of agencies given the authority by legislation to adopt regulatory acts. Among the regulatory authorities are the Verkhovna Rada (parliament), the president, the Cabinet of Ministers, the National Bank, other state authorities, central executive agencies, the Verkhovna Rada of the Autonomous Republic of Crimea, the Council of Ministers of Autonomous Republic of Crimea, and agencies of local self-government. Other entities belonging to the regulatory agencies are the territorial agencies of central government, specialized state institutions and organizations, noncommercial self-governing organizations that carry out guidance and management of obligatory state social security (if authorized to make regulatory decisions). This substantial list of regulatory agencies demonstrates the importance of regulatory policy and makes it necessary to conduct quantitative and qualitative analysis on the benefits and costs of every regulatory act.

The basic legislative document that guides regulatory policy in Ukraine is the Law of Ukraine “On the Principles of the State Regulatory Policy in the Field of Economic Activity.”³ The purposes of this legislative act are the

- perfection of the legal regulation of economic and administrative relations between the representatives of business and government

2 “On the Principles of State Regulatory Policy in the Field of Economic Activity,” September, 11, 2003, No. 1160–IV.

3 Ibid.

- stimulation of acceptance of expedient and effective regulatory acts by public involvement in the rule-making process
- implementation of deregulation by elimination of legal acts that have lost validity and interfered with the management of market mechanisms (self-regulation) and private institutions

The law requires implementation of state regulatory policy in the following ways:

- establishment of a unique approach to preparing analysis of regulatory impacts and monitoring the implementation of regulatory acts
- procedures for publicity, revision, and systematization of regulatory acts
- unacceptability of regulatory acts that are inconsistent or ineffective
- monitoring of effectiveness and information procedures for publicity about implementing regulatory activity

Pursuant to the Cabinet of Ministers of Ukraine,⁴ the following requirements are set for conducting the impact analysis of a regulatory act:

- Define the problem needing to be addressed by the regulation, and define the objectives of the regulation. All acceptable alternative methods of achieving the noted objectives are enumerated, and arguments concerning advantages and disadvantages of the selected method of regulation are listed. Mechanisms and measures are suggested to be applied to the problem, and the expected indexes of effectiveness of the regulation and length of its possible duration are described.
- Determine the cause of the problem and why it cannot be solved by means of market mechanisms or current regulatory acts; note the subjects on which the problem has a negative influence.
- Determine at least two acceptable alternative methods of achieving the objectives of the state regulation, and list the advantages and disadvantages of each.
- Describe the mechanism and measures to apply to the problem, and identify and determine the efficiency of basic principles and methods to achieve the objectives of the state regulation; detect the external factors expected to influence the regulation and identify and compare the circumstances, positive and negative, that might affect implementation of the requirements of the regulation; indicate the frequency of execution of state control and supervision after the regulation is implemented.
- Determine the expected results of the regulatory act using benefit-cost analysis in either simple form (list the expected positive and negative factors) or in

4 "On Ratification of Methods of Conducting Impact Analysis and Monitoring of Effectiveness of Regulatory Acts," March, 11, 2004, No. 08.

more sophisticated form (with application of various economic models). When conducting benefit-cost analysis, a certain period is set, and the magnitude of every benefit and cost is calculated using statistical data, scientific studies, data questionnaires, and data from other sources.

- Measure the effectiveness of regulatory acts at different points of time following its commencement, including
 - receipts to state and local budgets and state special-purpose funds related to enactment of the regulation
 - number of households and/or physical persons that enactment of the regulation will affect
 - cost and time expended by the households and/or physical persons related to implementation
 - requirements of the regulation
 - level of knowledge of households and/or physical persons about the substantive provisions of the regulation

The law requires periodic monitoring within the terms set by Article 10 of the Law of Ukraine “On the Principles of State Regulatory Policy in the Field of Economic Activity.” Thus, there is a sufficient legislative base for regulatory activity. However, administrative and organizational measures are still needed to allow its effective implementation through collaboration among state agencies, private business, and the public.

Experience of other countries with regulatory activity

For Ukraine it is interesting and instructive to review the experience of other countries with regulatory reform, especially countries that have attained a considerable level of economic development, such as Canada, the United Kingdom, France, and Germany. The experience of these countries shows that the introduction of a balanced regulatory policy invigorates economic processes and attracts investments to a country, in particular for small and medium-sized enterprises (SME).

For example, Canada introduced a regulatory policy as a system of effective state regulation. In the 1970s, the Economic Council of Canada began a program of specialized studies determining the consequences of state regulation by central and local levels of government. On the basis of these studies, a series of recommendations was developed to improve the process of regulatory development (Analytical Centre “Akademiya” 2005b).

Pursuant to the requirements of regulatory policy, at the introduction of new normative-legal acts, the Canadian state administration agencies are obliged to prove that

- a risk or problem for society exists, intervention by government is expedient, and introduction of regulation is the best alternative
- the public took part in consultations during development and implementation of changes to regulations and regulatory programs
- benefits from regulations exceed their costs to citizens, government, and business
- economic growth and employment are enhanced and the actual normative-legal act does not create additional regulatory barriers

In particular, regulatory agencies must prove that

- the information and administrative requirements do not exceed the minimum necessary and result in no additional charges for citizens
- the regulations take into account the specific operating conditions of small business
- the regulations take into account suggestions related to the change of regulatory requirements
- the standards of regulatory process control were adhered to, the proposed regulation is legitimate, and there is a mechanism for monitoring the regulation after implementation

In the United Kingdom, a governmental decision formed an interdepartmental commission to study questions of state control over enterprise environment, with the purpose of improving regulatory activity. This commission concluded that implementation of governmental regulatory requirements imposed considerable additional costs on business, especially on small enterprises. Consequently, in the mid 1980s, the British government developed a strategy of addressing the problem of excessive state interference in entrepreneurial activity. This strategy, known as “Initiatives of Deregulation,” began two important directions of governmental activity (Analytical Centre “Akademiya” 2005a): review of the existing base of regulations of enterprises, resulting in concrete suggestions for deregulation; and introduction of an institute to design suggestions in relation to new regulations. The consequences of improved regulatory activity became evident in increased growth of the economy and upsurge of investments in the country.

The considerable success of the French economy is also related to the focused and logical regulatory policy of the government. The government built on the support of public organizations, in particular professional and interprofessional association branches, providing feedback from the society, including feedback on regulatory policy. Some French professional organizations have plenary powers and duties, conducting quantitative analyses of possible alternative state regulations, analyzing their influence on the economy with the purpose of soliciting remarks and suggestions

from all interested groups, and monitoring the effectiveness of introduced regulation. Thus, stability, predictability, and social orientation are determining principles of the regulatory policy of France.

The experience of Germany, in particular lessons to be learned from the so-called nitrofen scandal of 2002, can also be instructive for Ukraine (von Cramon-Taubadel 2002). Since it followed the crises caused by bovine spongiform encephalopathy (BSE) and foot-and-mouth disease in Europe, the scandal intensified the doubts and concerns of consumers regarding food safety and the systems of agricultural production and food retailing.

The scandal, as well as the crisis caused by BSE a year earlier, demonstrated the great value of strict food safety control. Consumers are not able to determine whether food products are safe. Therefore, they must have confidence that the system for ensuring the quality of food products works and that any negative results will not be hidden to protect commercial interests. Rather, negative findings will result in quick actions directed at minimizing harm to consumers.

Another lesson learned from such scandals, as von Cramon-Taubadel stresses, is that it is impossible to rely on the producers of food products to perform the necessary quality control of their products (2002). Careful control of food safety is to be done by independent institutions authorized to carry out controls at any time, without previous warning or any limitations on their work. These institutions can be either private or state. It is possible that private firms will work more effectively and with lower costs over the long term than state laboratories. However, private firms authorized to conduct monitoring of the safety of food products must be fully independent of agricultural producers and food enterprises that they monitor and legally obliged to immediately reveal to appropriate state agencies any contamination found. Regardless of who monitors food product safety, it is important that responsible employees are paid according to their qualifications and responsibilities. If not, bribery and other forms of corruption are likely to be a great temptation.

The nitrofen scandal and similar crises related to the safety of food products in Germany and other countries demonstrated that respective ministries of agriculture were not the best guarantors of safety of food products (von Cramon-Taubadel 2002). A ministry of agriculture (in any country) is inclined to identify itself as a defender of producer, rather than consumer, interests. When producer and consumer interests conflict, politicians face a difficult choice. For example, in the BSE case, the Federal and Land Ministries of Agriculture declared for several years that there was no BSE in Germany. There was even some indication that its existence was intentionally hidden to avoid crisis and defend the interests of German agricultural producers (von Cramon-Taubadel 2002). In reaction to the crisis, Germany renamed the Ministry of Food, Agriculture, and Forestry to the Ministry of Consumer Protection, Food, and Agriculture. However, speculations about insufficiency of these measures were expressed, the claim being that the defense of consumers on one side and agricultural

policy on the other must be fully separated and transferred into the jurisdictions of different departments.

The question of food safety in Ukraine will become increasingly important, especially in connection with the expansion of export possibilities for agricultural and food products. Therefore, poor-quality products in international markets could negatively affect the country's image, which Ukraine—already associated with the Chernobyl catastrophe and other ecological problems by consumers in Europe—can ill afford. Ukraine still stores (in conditions far from ideal) mineral fertilizers and poisonous chemicals that are forbidden in the West. Periodic reports in mass media about poisoning of individuals and whole territories adjacent to these storage areas confirm this speculation. Thus, it is impossible to categorically deny the possibility of contaminated food products in Ukraine.

The basic task of regulatory policy in these examples is not to create problems for citizens and businesses, but to provide the economic advantages from regulatory acts. Collaboration between the state, private business, and civil society is the key component of a modern regulatory policy. Food safety is not only a medical or ecological issue, but also an economic one.

Stages of reform of regulatory policy in Ukraine

In Ukraine, attempts to improve state regulation of the economy began in 1997. Using a series of presidential decrees and regulations by the Cabinet of Ministers, the government was partly successful in introducing a unique state regulatory policy for economic activity at both central and local levels of executive agencies. In 1998 the president⁵ introduced the philosophy of minimal intervention by the state in developing the society and guaranteeing democracy and stability. To reduce the burden of regulation on enterprises, the president of Ukraine issued two decrees.⁶

Implementing the requirements of decrees, the Cabinet of Ministers accepted a series of regulations to guide publicizing information, "On Activity of Executive Agencies and Exposition of Orders on Conducting Regulatory Activity." The cabinet also issued a decree⁷ aimed at improving terms for developing democracy, promoting citizens' rights to participate in the management of state affairs, and providing access to information on activities of executive agencies. Another decree⁸ lays out the sequence and monitoring requirements for analyzing the effects of regulatory acts⁹ (Lyapina, Lyapin, and Demchakova 2004).

5 "On Conception of Administrative Reform in Ukraine," July 22, 1998.

6 Decrees of the president of Ukraine No. 79/98, February, 3, 1998, "On the Removal of Limitations that Restrain Development of Entrepreneurial Activity" and No. 89/2000, January, 22, 2000, "On Introduction of Unique State Regulatory Policy in the Field of Economic Activity."

7 "On the Order of Guidelines on Publicity via the Internet Regarding Information about Activity of Executive Agencies," No. 3, January, 4, 2002.

8 "On Approval of the Analysis of Effects and Monitoring the Effectiveness of Regulatory Acts," No. 308, March, 11, 2004.

9 "On the Principles of State Regulatory Policy in the Field of Economic Activity," No. 1160-IV, September, 11, 2003.

In June 2005, the president issued a decree¹⁰ establishing principles of state regulatory policy for economic relations. The purpose is to meet the requirements of the market and achieve a balance of interests between citizens and the state. The goal is to improve the skills of regulatory agencies, in particular by introducing a training program for employees of executive agencies and local self-government. The training provides instruction on implementing the regulatory law, assessing the system, coordinating regulatory acts among industries, and providing the budget for financing measures and programs to implement state regulatory policy. It also provides for conducting analysis of regulatory acts of the Cabinet of Ministers in accordance with principles of state regulatory policy by central and local agencies, the main developers of regulation proposals.

The president's decree also contains concrete terms for creation of working groups to revise existing regulatory acts in national and local agencies. These groups must conduct the analysis and prepare suggestions to bring existing regulatory acts into accordance with national principles of regulatory policy.

The main advantage of this decree is the training of senior professional personnel on regulatory policy, which will increase the efficiency of executive agency activity. Comprehensive knowledge by managers of the basis of regulatory policy, types of insolvency, and state regulation enables them to determine the limits of the regulatory powers of the market and the state. It is important to eliminate contradictory regulations.

Despite the positive aspects of the decree, there are also a series of contradictions:

- Too little time was allowed to create the working groups to revise regulatory acts. These groups need to be assembled from disparate, highly skilled specialists from separate disciplines.
- Too little time was allowed to complete the work. A one-month term for revising a regulatory act is too short and will affect the quality of the work and the resulting measure (legal document).

It is necessary to stress that this decree does not solve all regulatory policy problems, in particular predictability, transparency, and consideration of public opinion. Predictability consists of the sequence of regulatory activities, consistency of the policy with the objectives of state policy, and strategies to prepare drafts of regulatory acts allowing businesses to plan their activities. Transparency and consideration of public opinion include openness to both individual and legal entities and their associations (interested entities) at all stages, obligatory consideration of initiatives by the regulatory agencies, remarks and suggestions given by interested entities, promptly bringing the accepted regulatory acts to the notice of interested entities, and providing information to the public about implementing the regulatory activity.

10 "On Some Measures Providing for Implementation of State Regulatory Policy," No. 901/2005, June 1, 2005.

Indisputably, it is necessary not only to conduct continuous monitoring of the implementation of legislative acts, but also to arrange an institutional base for a regular public-private dialogue between businesses, citizens, scientific institutions, and public authorities. In practice, a regulatory policy is a continuous process of permanent self-control by the state: following administrative guidelines and undertaking analysis of drafts and ratified regulatory acts for their socioeconomic efficiency.

Current state of regulation

The agricultural sector of the economy is especially sensitive to regulatory processes. State regulation in the agricultural sector gives quite contradictory results in the areas of efficiency and balancing the needs of the state with market regulation. This, in turn, makes clear the urgency of addressing questions of regulatory policy, especially on regulatory effects and assessing the effectiveness of regulatory acts. If the interests of all involved are not balanced, a complicated socioeconomic situation can result. Consequently, actions of the state that cause the decline of business activity in agriculture, loss in investment attractiveness of the sector, and accumulation of legislative acts that contradict each other should be avoided.

Examples of unsuccessful agricultural regulatory policy in Ukraine were the actions of government in the grain market in 2002–04 and the regulatory decisions of the new government regarding grain and meat markets in 2005. Actions in the grain market were characterized by direct state interference on moving grain between regions, pricing of grain and processed products, and regulation of export and import of grain. As a result of weather conditions, the harvest of winter wheat in 2003 turned out to be smaller than the 2002 harvest. However, trying to stabilize the grain market, the government's actions had the opposite effect from what was intended. The actions taken administratively interfered with activities of participants in the grain market: in particular, selecting train cars for transporting the grain, and commanding grain producers to sell grain only on regional exchanges at below-market prices. All these actions limited the ability of grain proprietors to freely market their products, violated a number of laws and legislative acts, and essentially functioned as an indirect additional taxation of agriculture (von Cramon-Taubadel 2004, 183–90).

Attempts to personalize responsibility for the crisis were another inadequate step. Public servants at different levels of management were exempted, but criminal cases were opened against others. The stress on individual responsibility created an atmosphere in which bureaucrats, especially on the regional level, did everything to seem “active.”¹¹ As a result, the Ukrainian grain market was divided into separate regional markets. By giving authority to regional governments to interfere in the market, one of the most important mechanisms by which markets absorb or reduce shock—market integration—was removed.

11 Resolution, Council of Ministers of Ukraine (CMU) No. 1150, July 24, 2003.

The only direct interference that might have helped, given the situation in the grain market in Ukraine in 2001 or 2002, would have been the creation of state and private grain stocks. However, despite repeated promises by the government, funding was never granted to create the reserves.

With respect to unfounded statements by the government, it is also necessary to note that a lot of grain was exported in 2002. Not having the ability to store grain, producers were thankful for the ability to complete export transactions quickly.

The stabilization of the grain market was viewed by the government as a political, strategic, and, consequently, secret issue. Information about prices, volumes of government purchases, and disposal of grain was not accessible to market participants. Government actions must be transparent and clear, and the establishment responsible for stocking grain must constantly report its volumes. In this case, market participants can deal with normal sources of risk and not have to worry about new sources of risk, such as a change of policy. It should be noted that one of the elements of regulatory reform required the Ministry of Agrarian Policy to be engaged in monitoring markets and collecting and sharing market information with participants. However, the reality looked different: necessary information was either unavailable or classified.

The increase in the grain price was mostly beneficial to producers. However, the increase in the price of bakery products had the opposite effect, and the government's 2003 actions in this market also deserve criticism. Administrative introduction of marketing margin controls for bread and bakery products resulted in disincentives for producers, bankruptcies of bakery enterprises, an increase in the "shadow economy" part of the sector, a decrease in production and quality of bakery products, and consequent shortages, especially in rural areas.

The attempt to hold bread prices down as a food assistance measure was ineffective, because such a policy provides low prices for poor and rich alike. A more effective way to direct food assistance toward the most vulnerable population is a system of food coupons that would allow holders to buy a certain amount of products at a lower price. Another possible solution is a policy to identify the poor through means testing. The government would subsidize foodstuffs that have a negative income elasticity. For example, it would subsidize the types of bread consumed only by the poor, i.e., the kind of consumption that decreases as income increases.

In 2004, when over 40 million tons were harvested, administrative interference in the grain market continued. The government, through *Khlib Ukrainy*¹² and the Committee for State Reserves, purchased 3.6 million tons of grain, paying UAH800 per ton for third-class milling grain, UAH600 per ton for rye, and UAH450 per ton for forage barley. For this purpose, UAH200 million was allocated to guarantee purchases of 500,000 tons of grain by *Khlib Ukrainy* and UAH600 million to purchase 1 million tons of grain by the National Reserve. At these prices, there would only have been

12 *Khlib Ukrainy* is the state-owned grain facility that serves as the agent for government intervention in grain markets.

enough funding to purchase half of the planned volume. As expected, agricultural producers were not paid in a timely manner. By mid-October 2004, the Committee for State Reserves had paid only for 54 percent of the grain purchased, although the purchase plan was fully fulfilled.

According to a directive to be actively involved in the question of price policy, every head of state regional and district administration was required to personally communicate with producers. Maintaining stable bread prices through interventions and pledge operations remained the main objective. The task was to control the base bread price and the share of wages in the cost (not lower than 15–20 percent). However, 3.6 million tons of grain stockpiled against 40 million tons harvested is not enough to substantially affect market price. In addition, the average state price turned out to be too high to conduct active trading both on internal and external markets. Due to the high world grain harvest in 2004, the world price was decreasing and, in turn, “pressing” on the internal price in Ukraine. For example, at the time the advance price of food grain reached UAH800 per ton, the world price was US\$135 per ton (UAH715). This meant that the high cost at which the state purchased the grain made it impossible to dispose of the surplus without losses. Thus, this grain will either remain in state storage for a long time and bring losses, or it will be sold, also with likely losses, for flour.

In trying to control the price, there was also an attempt to administratively pressure market operators. The practice of exploring grain trade limitations on regional levels was renewed. The mechanism of obligatory sale of grain through an exchange commodity market—regional exchanges—was applied. Such an “obligatory” registration obstructed the grain trade as the cost of disposal substantially exceeded average world prices and automatically made the purchase of grain by traders unprofitable. Moreover, businesses were forced to pay UAH1.5 per ton on for an exchange seal on a contract, a formal procedure that increased the already considerable marketing costs for market operators. At the forecast volume of 8 million tons, this administrative requirement would result in a decrease in the profits of agricultural producers of UAH12 million. In addition, in some regions, the priority to purchase grain was granted to businesses structures linked to the local government to satisfy regional requirements that actually monopolized the market. No more than 70 producers participated in tender purchases, even though there were almost 10,000 large producers and over 43,000 private family farmers registered in Ukraine.

On the other hand, compliance with resolutions passed by regional administrations (for example, Kirovograd OSA, Zaporizhya OSA) related to the marketing of agricultural products made it impossible to export and hindered the interregional movement of grain. Some of the resolutions passed by regional administrations imposed rules regarding exchange seals or proper registration certifications, failure to obtain quarantine certificates, or to register import and export of grain varieties. In some regions, the “services” of government agencies were involved to enforce these market interventions.

For example, the authorities of Dnepropetrovsk regional administration appealed to regional leaders of the Ministry of Internal Affairs (MDA), Security Bureau of Ukraine (SBU), and the office of the public prosecutor to investigate reasons for lowering grain prices. This and similar actions by local government forced grain traders out of regional markets and artificially supported guaranteed prices. Consequently, producers found it impossible to dispose of their grain. Higher stocks resulted in increased storage costs and spoilage, and grain companies were forced to cut down on their activities in Ukraine and move their capital abroad.

Taking into account that the grain export potential of Ukraine in the 2005–06 marketing year is 8–10 million tons and that the state budget does not allocate the funds to maintain set minimum prices, a crisis on the national grain market is likely. The grain producers will not be able to sell the grain, as traders will not buy it at higher than world prices. Thus, more than 7 million tons of unsold grain harvested in 2004,¹³ which was bought by the state at higher than world prices, will likely remain in Ukraine.

These examples of unsuccessful regulatory policy should serve as a lesson and warning to avoid similar errors in the future. However, the new government appears to be continuing some of these practices. In 2005, minimum purchase prices higher than world levels were established for milk and grain. Another not-so-successful example of government's regulatory actions in the meat market occurred in the spring of 2005. Wishing to avoid shortages and lower meat prices, the government required local authorities to select trading points at the retail market for the meat producers and to fix prices. In doing so the government induced agricultural producers to carry on retail business activity, which is not typical for them. Overlooked was that when a producer sells meat at retail, he or she loses the VAT compensation as well as the subsidy (headage payment) payable by the state when meat is sold to processing enterprises. Clearly, such policies cannot not substantially affect meat prices and improve the meat market.

Current state of agricultural product quality control in Ukraine

Quality control of agricultural products and foodstuffs is one of the most important factors affecting the competitiveness of these products on domestic and international markets. Substantial measures will be needed to improve the current state of affairs in Ukraine. Steps that could be taken range from refusal to admit food products for sale on informal and unregulated flea markets (sale of raw products without any quality or safety control) to creation of modern laboratories for intensive control of raw agricultural materials and foodstuffs. Three examples of current controls and necessary modifications in agriculture are discussed below: licensing of operations on plant quarantine and disinfection of exported grain, certification of seed varieties, and quality control of milk and milk products.

13 Ministry of Agrarian Policy of Ukraine.

Licensing plant quarantine and exported grain disinfection operations

Some time ago, Ukrainian companies raised the question of being permitted to conduct grain disinfection themselves in order to compete with the monopoly of the Irish company, Pest Control. However, investigation by the Ukrainian antimonopoly committee lasted more than a year, despite repeated appeals by grain market operators.

The analysis of legislative acts regulating the question of licensing confirms that they are late and contradictory. It was not until January 1, 2004 that an updated issue of the law of Ukraine “On the Quarantine of Plants” granted nongovernmental enterprises and institutions the right to conduct such activities. In June 2004 the changes were implemented by the new quarantine law and the Law of Ukraine “On Licensing Certain Types of Economic Activity,” in which the licensing activity was approved for disinfection of grain shipments. In that same month, the law of Ukraine “On Introduction of Changes in Some Laws of Ukraine on Licensing of Activity on Conducting Fumigations of Sub-Quarantine Materials and Objects” changed some regulations to bring them into compliance with current law (Makarenko 2005, 14–16).

After the enactment of No. 1164 on September 8, 2004, the Ministry of Agrarian Policy was to issue licenses to conduct disinfection of subquarantine materials and objects crossing the Ukrainian border and quarantine zones. However, two months later, the order of the State Committee was adopted to address the questions of regulatory policy and business. The Ministry of Agrarian Policy introduced “On Claim of the Licensed Terms of Implementation of Economic Activity from Conducting of Disinfection of Sub-Quarantine Plants and Objects that Move through a State Border and Quarantine Zones.” The order specified organizational, technological, and qualifying requirements of the businesses. Later, a statute was ratified on licensing of implementation of economic activity and conducting of disinfection of subquarantine materials and objects and defined the composition of the license commissions. Such an unfortunate design of the mechanism to issue licenses became one of the origins of the international misunderstanding related to quality of Ukrainian grain in 2003–04. Only after numerous legal documents are accepted and approved can competition on the market of fumigation services be formed and the cost of registering grain export operations decline.

Certification of new seed varieties

Unlike the generally accepted system of introducing new seed varieties to production used in most countries of the world, Ukraine still uses the Soviet system of seed certification. To enter a new seed variety of foreign or domestic origin, the variety must be tested for at least two, and sometimes three, years by the State Commission (hereafter Commission) for variety testing and protection. The process of variety registration begins when a “seed establishment” (a company wishing to register a new variety) applies for registration with the Commission. When the application is accepted, the company delivers a sufficient amount of seed to the Commission’s testing department

to create approximately 20 test areas. The test seed is planted all around Ukraine for Commission members to determine how a variety behaves in different ecological areas. Every year the yield indices of the variety are established and compared to the mean yields of standard varieties of the same culture in the same ecological areas.

After two years of testing, the Commission presents the data on all varieties that passed testing to an expert council, which decides whether to add a variety to the state seed register and thus recommend it for use by agricultural producers. There are expert councils for wheat, vegetables, oil-bearing seeds, etc. Each expert council consists of 15–20 state and scientific experts, such as soil specialists, agriculturists, plant pathologists, etc. The Commission has the right not to add a variety to the register or to require an additional year of testing to reach the final decision.

If a new variety has high yield indices, is pest-resistant, and its productivity exceeds the results of standard (currently grown) varieties by more than 5 percent, it is added to the list of prospective varieties after the first-year harvest. If a variety is added to the list after the first year of testing, it is possible it will be confirmed and registered after the second year of testing.

Every year the Commission supervises the testing of thousands of varieties of different plants and varieties. Foreign seed companies pay fees during different stages of testing and registration. The Commission negotiates an individual agreement with every foreign seed company about the work performed. According to the specialists at the Commission, fees are determined by discussing the necessary tests for every variety presented for registration. A typical amount takes into account charges for the application, testing, and registration, as well as annual registration charges for varieties already on the list of approved varieties.

The information communicated from international seed companies doing business in Ukraine indicates that the sum paid for variety registration can fluctuate from a few thousand to tens of thousands of U.S. dollars a year. The cost of seed registration and time spent on the registration process is reflected in the company's production costs. In the end, the costs are paid by agricultural producers in form of higher seed prices.

The system of certifying new seed varieties in Ukraine differs from the system used in the United States, where seed companies test and release new varieties when they feel they can effectively compete on the market (Neubert 1998). In this case there is no requirement to apply for state permission to sell a new variety. Such a system has allowed U.S. farmers to be ahead of most countries in the quality of embryonic plasma. As experience shows, farmers who are the first to adopt a new technology enjoy considerably greater benefit than those who adopt later when the new technology has become an industry standard and its adoption turned into a necessity to sustain competition.

The long and expensive way of introducing new varieties in Ukraine harms Ukrainian agricultural producers. Agricultural enterprises use varieties for 20 or more years. In this situation, Ukraine cannot hope for its agriculture and food retail industry

to be competitive. Therefore, the state should establish simplified and accelerated procedures for registering new seed varieties for companies wishing to supply seed to local users. In parallel, it is also necessary to develop a local seed stock in Ukraine.

Statements that the state protects agricultural producers with the existing system of introducing new seed varieties are unconvincing. Farmers the world over know that planting high-quality seed is necessary. Seed companies know that if they do not sell high-quality products at competitive prices, they will be forced out of business. These companies spend millions dollars on developing new, more productive hybrids, and cannot afford selling low-quality products. If they do not offer high-quality products, their competitors will force them out of the market. Agricultural producers do not benefit from the cautious state control in the Ukrainian seed industry. Naturally, the question arises: who finds this slow and inefficient regulation process advantageous? Certainly not farmers or seed companies.

Another widely accepted belief is that limiting imports of new improved varieties protects the local seed industry from international competition. There is some truth to this, but as Soviet experience testifies, inhibition of new ideas, technologies, and competition results in economic stagnation. Without competition, there is very little stimulus for enterprises to perfect their products or services. Competition is the stimulus of economic development; it supports change and helps new ideas and new and improved products to appear. It also cuts prices and upgrades services for clients. For agricultural producers it means lower seed prices, better quality, and higher yields. Plant breeders in Ukraine are respected worldwide for their achievements in sunflower, grain, and other varieties. Were liberalization of the seed industry to occur, these plant breeders and their institutions would have the potential to cooperate with international partners. Such collaboration would be much more advantageous for the scientists, the local seed industry, agricultural producers, and in the end, the whole population of Ukraine.

Quality control of milk and milk products

In Ukraine, no state agency controls the quality of raw milk, neither as a regulative institution, nor as a mediator in disputes between processors and producers. In France, these functions are carried out by professional and interprofessional milk organizations. State agencies must be careful not to overburden the connections between producers and processors by imposing excessive regulation. Similarly, it is not desirable to overload state agencies with this function. Currently in Ukraine, processing enterprises are unable to purchase and align the equipment to conduct tests to determine conventional amounts of bacteria and somatic cells in milk. Therefore, this function can be carried out by the state regulatory and control agencies, or professional and interprofessional organizations of the respective market participants.

Ukrainian milk products already have some European export markets, such as casein for industrial rations, powdered milk for animal feed, and butter. Since it is

difficult to obtain analysis of milk quality in Ukraine, powdered milk for export is not recorded as a food product because of the low quality of raw milk from which it is produced. Prices for powdered milk for animal feed are lower than for food products. Therefore, it has become a priority to upgrade milk quality so that food-quality milk products may be exported at a higher price. Not long ago there was a scandal in Europe related to the poor quality of powdered milk from Ukraine: traces of antibiotics were found. Even an anecdotal case can spoil the reputation of a country in the international market for a long time. This scandal has already cost Ukraine too much.

In Ukraine, the training of specialists organized by state agricultural institutions or milk processing enterprises is rarely conducted. A very important condition for increasing milk quality is the exchange of information among the specialists of the Ministry of Agrarian Policy, the departments of agriculture of state oblast (district) administrations and districts, and the workers in milk processing businesses and enterprises. All personnel engaged in the milk industry, its regulation, production, or processing are obliged to exchange information on practical methods relevant to producing high-quality milk. There is an important role to be played in this regard by professional and interprofessional producer and processor associations.

At the minimum, the quality of raw milk should be controlled by the processing enterprise as well as the appropriate state regulatory agency. Inspection should be carried out to guarantee compliance with state standards. In a processing enterprise, milk quality control is needed to secure supplies of high-quality milk to be used in production of different types of dairy products.

International standards for raw milk quality are becoming stricter. If a processor wants to export milk products to another country, he has to prove that the raw material entering the enterprise meets accepted international quality standards. Ukraine should consider the examples of some countries that recently became EU members. A considerable share of milk and milk products from these countries did not meet the EU quality standards, and producers had to either stop production or invest in facilities to ensure proper quality.

The two most important indexes of milk quality are the amount of bacteria and amount of somatic cells (Savello 1998). To maintain high-quality milk, the amount of bacteria has to be less than 100,000 units per milliliter. The amount of somatic cells became the major index of standard in EU countries, and it cannot exceed 400,000 per milliliter. The requirements are very strict and embody a standard for any milk industry that aims to be competitive in the world market.

Tests for somatic cells in milk have to be carried out in a proper laboratory with the necessary equipment. This test can be conducted one or two times per month in a state or private laboratory together with the common tests for amount of bacteria and composition of milk (reference tables of fats, albumens, lactose, and general consistency). The results of these tests will be of value to both producers and processors.

The former can use them to demonstrate changes in animal productivity and health, the latter to determine payments to the milk producers.

Two international organizations working under the auspices of the UN that provide important information about world production and standards of milk products are the International Dairy Federation (IDF) and Codex Alimentarius Commission of the Food and Agriculture Organization (FAO) and World Health Organization (WHO). IDF distributes a number of documents containing technical and commercial information as well as milk product standards accepted in the world. Codex Alimentarius provides information on the accepted standards that have been discussed and coordinated by member countries. Ukraine is a member of the FAO. It needs to strengthen its connections and intensify information exchange with IDF and Codex Alimentarius. The state and private milk industry enterprises must extend their membership and increase their participation in these organizations.

Summarizing the discussion of agricultural product quality and standardization, it is possible to conclude that transformation from the “prohibition and permission” principle to the “agreement” principle has to be the basic direction of agricultural regulation policy reform, with priority on adoption of international standards to guarantee food quality and food safety.

Regulation of food safety in the context of WTO agreements

Food safety of raw materials and processed products is one of the key components of economic security of every country. Food safety is determined by the economy’s ability to exert control over high-quality food production on the principles outlined in international agreements.

Ukraine’s hope to join international organizations such as the WTO and the EU compels it to harmonize its domestic legislation with the requirements of these organizations. Especially crucial are the current questions of standardization of food product safety that in international practice is regulated by the SPS Agreement of the WTO. The SPS Agreement is an attempt to provide every sovereign member state of the WTO an opportunity to defend the health of its citizens, plants, and animals while taking into account the specific circumstances of each country. Regulatory acts applied by each country cannot act as obstacles to free trade—this is at the heart of the WTO.

The requirement to develop, ratify, and implement the SPS Agreement was conditioned on legal agreement on two concepts. On one side, the market economy requires an open market, removal of obstacles preventing smooth movement of commodities, exclusion of limitations precluding a proprietor from selling his products, removal of administrative barriers, and so on. On the other side, there is the obligation to protect the health and lives of people, animals, and plants—which is possible only by strengthening regulation.

Harmonization of national standards and certification procedures pursuant to international agreements is a key prerequisite for a country to be accepted into the WTO.

To facilitate the acceptance process of Ukraine, it is important to bring Ukrainian legislation on the principles of harmonization of sanitary, veterinary, and phytosanitary standards into accord with the appropriate international standards.

Also there are some central tasks to be implemented before Ukraine enters the WTO (EuropeAID 2005):

- step-by-step revision of Ukrainian legislation in terms of Instructions of the Council of Europe 93/43/EU about the hygiene of foodstuffs
- amending the legislation about monitoring of products that will help eliminate technical barriers to international trade
- legislative rules related to animal defense and acceptance of the relevant laws
- application of the Hazard Analysis and Critical Control Point System, which consists of analyzing potential risks and determining problem spots in production
- step-by-step convergence of Ukrainian legislation on the official control of foodstuffs to the requirements set by the suggestion on regulation by the European Parliament and Council of Europe about the official control of forage and foodstuffs

Such obligations arise from the international agreements to which Ukraine is a signatory, and also from the mandate to conduct suitable measures within the framework of national legislation. Expansion of the EU and the necessity to establish the best economic linkages with new EU neighbors challenged Ukraine with the task of estimating how well the national food safety legislation and phytosanitary standards respond to the world and EU requirements.

Ukraine has a series of normative acts in this area. The Ukrainian legislation on SPS measures, like legislation of many countries, consists of a series of laws and regulations designed to protect human, animal, and plant health (EuropeAID 2005):

- veterinary legislation
- legislation on sanitary and epidemiology safety of the population
- legislation on plant quarantine
- legislation on food safety
- completion of the Ukrainian legislation in the area of SPS measures; its convergence with EU legislation and WTO requirements as an incentive to develop international trade and integrate Ukraine to the world economy

The quality standards for agricultural products within the WTO framework are regulated by the Sanitary and Phytosanitary Measures Agreement in accordance with current Ukrainian law. Therefore, it is important for Ukraine to require that national standards be developed and approved on the basis of the standards developed by international organizations, in particular by the Codex Alimentarius Commission,

the International Animal Health Organization, and other international and regional organizations operating within the framework of the International Plant Protection Convention (EuropeAID 2005).

National standards resulting in a higher level of protection are used when there is a scientific consensus that stricter standards are needed to provide a desired level of human, animal, and plant health as well as environmental protection; stricter standards are based on risk estimates, as required by the circumstances to protect life or human, animal, and plant health.

When current scientific consensus is insufficient, SPS measures can temporarily be firmly established on the basis of present information, including the information received from the relevant international organizations and from measures applied by other WTO members. Temporarily ratified measures must be reviewed as new information becomes available using the relevant risk estimation.

In accordance with the Article 2 of the SPS Agreement, WTO members have to ensure that any SPS measures are used only in the amount necessary to protect human, animal, or plant health; that measures are based on scientific principles; and that none of the member's actions proceeded without sufficient scientific basis.

The national standards of WTO members are required to be periodically reviewed to determine whether they are in agreement with the WTO requirements and have a scientific basis. Only reviewed standards can be continued. It is desirable to delegate the task of reviewing national standards of Ukraine to a central agency in standardization and certification industry.

The SPS agreement also dictates that all SPS regulations be published so all WTO members have a chance to become acquainted with them. For this purpose, periods for acquisition action and printing of new regulations in the standardization and certification industry are determined. Enough time must be allowed for interested parties in other WTO countries to become familiar with the new rules.

In accordance with Article 7 of the SPS Agreement, WTO members must report changes in their SPS measures and provide information on the measures according to rules listed in Annex B of the SPS Agreement. In particular, members define their procedures and report on introducing certain regulations in the standardization and certification industry, if the accepted regulation does not coincide with accepted international standards, instructions, or recommendations, or if the relevant international standard does not exist. The procedure requires the following (World Trade Organization 1995):

- publishing of a report introducing a certain standard; interested WTO members should be in a position to familiarize themselves with it and allowed to express their remarks in writing
- delivering a message through the WTO Secretariat to members specifying commodities that will be affected by the given standard, and listing the basis for introducing such a standard

- providing members with a copy of the presented regulation and, if possible, highlighting those parts that deviate from international standards

In accordance with Article 8 of the SPS Agreement, WTO members must adhere to positions in Annex C during the implementation of procedures of control, testing, and certifications.

A regulation defining compatible procedures of control, testing, and certifications has to provide

- standard terms for complying with the control, testing, and certification procedures
- regulations for declaration of foreign conformity certificates
- an opportunity for the declaring party to correct the document if errors are found
- report by the declaring party on the stages of procedure progress
- confidentiality of information on imported commodities, that arises or is given in connection with the procedures
- requirements ensuring that the information collected to pass the procedure is limited to the minimum
- equal terms necessary to complete the certification, control, and inspection procedures for all businesses
- a possibility to revise complaints related to implementation of control, testing, and certification procedures and make corrections when needed

Paragraph 3 of Article 1 of the SPS Agreement requires that WTO members base their SPS measures on international standards, instructions, and recommendations. According to Paragraph 3(a) of Annex A to the SPS Agreement, international standards, instructions, and recommendations related to food safety, veterinary preparations and pesticides, and other standard matters, instructions, and recommendations are set by the Codex Alimentarius Commission.

Thus, to harmonize national legislation with WTO agreements related to SPS measures, it is necessary to complement the current law with legislation based on international standards, instructions, and recommendations as outlined by the Codex Alimentarius Commission for food, by the the FAO's Secretariat of the International Plant Protection Convention for plant health, and the International Animal Health Organization for animal healthcare and prevention of zoonosis. The following Ukrainian laws are affected:

- “On Ensuring the Sanitary and Epidemic Safety of the Population”
- “On Quality and Safety of Foodstuffs and Raw Food Produce”
- “On Protection of Population from Infectious Diseases”
- “On the Quarantine of Plants”

- “On Seed”
- “On Pesticides and Agrochemicals”
- “On Veterinary Medicine”
- “On Apiculture”
- “On the Animal World”

International trade in foodstuffs grew substantially in the last decade. Almost 50 percent of total exports of fresh and processed fruits, vegetables, fish meat, nuts, and spices was exported from developing countries. However, the share of developing countries in traditional commodities such as coffee, tea, cocoa, and sugar decreased (World Bank 2005). While demand and supply play an important role influencing international trade, internal support of agricultural product and food safety are also crucial within the framework of the WTO. The case is particularly current in the Ukraine, which intends to enter the WTO. The basic directions of modern regulatory policy in member countries are determined by the decisions negotiated in the Uruguay Round. Two basic directions emerge:

- liberalization of terms of trade, as demonstrated by the decline of trade protectionism and agricultural subsidies
- development and intensification of food safety and standards related to plant and animal health; the fundamental objective is to create conditions for risk management as it relates to animal and plant pests and illnesses, and also pathogenic microbes and contaminations in foodstuffs

Food safety and food quality standards are aimed at decreasing the risk of contamination caused by the pathogenic microorganisms. However, new quality standards can become additional barriers to international trade, and can be discriminatory, especially for developing countries. One of the elementary tasks of implementing new standards are administrative barriers prohibiting transportation of products with pathogenic diseases. Effective SPS measures are considered to be among the most important elements increasing competitiveness of domestic products, together with macroeconomic stability, favorable climatic conditions, and developed market infrastructure. All these factors have to be combined for maximum effectiveness.

At the same time quality standards based on the WTO requirements are introduced, state and private businesses need to adjust as well. These changes have to be considered investments in building market infrastructure and upgrading food safety, as well as safety and quality of other products. In the last two decades, consumers in developed countries began to pay more attention to food safety. This public interest is related to the detection of chemicals, bacteria, and other contamination in foodstuffs. The presence of technology and introduction of the control system in the production process is an indisputable part of introducing quality standards.

When choosing a strategy for food standards, Ukraine should consider the following alternatives:

- resist selling products to markets with high quality standards, which would require considerable costs
- get involved in setting standards in bilateral agreements or within the WTO framework or the SPS Committee
- adopt existing standards and implement necessary steps related to legal, administrative, technical, and organizational measures needed to put these standards into practice

Claims have been made that standards are a barrier to trade for developing countries, because the costs to achieve and monitor standards can be high. However, reality shows that in many cases these costs are not high, especially when compared with the export profit potential (World Bank 2005). In addition, within the WTO framework, developing countries benefit from technical assistance provided by international agencies and country donors interested in increasing the quality of products entering their markets and guaranteeing food safety to their citizens.

Assistance provided to facilitate the introduction of international SPS quality standards for agricultural products and foodstuffs is important for the economy to grow, reduce poverty rates, and create favorable terms for additional investments and productive collaboration between the state and private businesses.

Studies of low- and middle-income countries showed that countries with high levels of economic development considered increases in their quality standards to be an expedient and necessary response to consumer demand. Countries with lower levels of development that did not introduce new standards experienced a decline in competitiveness of their national foodstuffs. Consequently, they suffered from financial, administrative, and other barriers that emerged with the introduction of phytosanitary standards. It is, however, necessary to carry out a cost-benefit analysis related to investments to upgrade food standards and improve methods of quality control for agricultural products and foodstuffs. Experience from many countries confirms that such analysis shows that the benefits of developing the agricultural sector in the long term exceeds the short-term costs.

For Ukraine, it is important that it

- becomes familiar with and adopts rules and requirements related to product quality that exist in relevant markets
- participates in international organizations and discussions related to problems of product standardization
- chooses a strategic approach to develop and implement quality standards oriented to prospective markets to secure a competitive advantage

Conclusions and recommendations

The state agricultural regulatory policy, as a part of its general regulatory activity, requires that certain limitations, norms, and rules regulating activity of market subjects are established. The primary purpose is to increase competitiveness of agricultural products and foodstuffs produced and sold by Ukrainian enterprises on internal and external markets. It is possible to differentiate between general and specific regulatory activity in the industry. The general activity includes influencing the functioning of markets by the state, creating favorable terms for bringing in external and internal investments, and regulating imports and exports. The specific regulatory activity includes measures regulating food safety, in particular SPS control of agricultural products and foodstuffs.

Ukraine has had a negative experience with regulating agricultural markets: state regulation has interfered with the pricing system and product movement between regions and outside of Ukraine, caused considerable harm to market participants and, in particular, to agricultural producers. Examples of such actions are governmental regulatory actions in the grain market in 2002–05 and the meat market in 2005.

To a great extent, a country's regulatory activity relies on how much it is integrated with the international trading system and, in particular, whether it is a WTO member. Thus, the fundamental objectives of modern regulatory policy of WTO member countries are determined by the decisions agreed to during negotiations. Two basic directions emerge: liberalization of terms of trade, as demonstrated by the decline of trade protectionism and agricultural subsidies; and development and intensification of food safety and standards related to plant and animal health.

Ukraine needs to enter the WTO as soon as possible. Therefore, adjustments of agricultural policies mentioned above must be considered by the Ukrainian government when developing agricultural regulatory policies. It is important that Ukraine emerge as a powerful player in international agricultural and foodstuffs markets. The country has considerable potential in these industries and has a comparative advantage in them compared to many other WTO members. Effective SPS measures have to be examined as one of the most important elements to increased competitiveness of domestic products, alongside macroeconomic stability, favorable climatic conditions, and developed market infrastructure.

At the same time, quality standards have to be introduced. These standards are based on WTO requirements and demand additional efforts and investment by state and private businesses. These costs need to be considered as investments in market infrastructure. During the last two decades, consumers in developed countries have begun paying more attention to food safety. Thus, the presence of technology and introduction of the control system in the production process becomes an indisputable part of introducing quality standards.

Government and private businesses play a role in introducing quality standards for agricultural products and foodstuffs. The government should revise existing regulatory

policy in this area and initiate substantial institutional changes in food safety provision. In particular, existing standards have to be adapted to WTO requirements. New standards, related to new and so far not well-regulated problems of food safety have to be introduced on the basis of “production to consumption” or “from field to table” concepts, to provide broad access for international inspectors controlling the production process and product quality in a country.

From the business side—and primarily from the side of trade organizations and processing enterprises—the introduction of new standards of food safety and introduction of systems of management and control of product quality should be initiated by their enterprises and by suppliers of raw materials (agricultural enterprises). This will translate into closer collaboration among agricultural producers, processing enterprises, wholesalers, traders, and supermarkets, and result in a smaller number of suppliers.

Already, it is possible to claim that the system of standardizing quality of foodstuffs has a tendency to become complicated, as standards have to take into account safety, quality, environmental protection, and social requirements. Therefore, the introduction of new standards is of special importance for developed and developing countries.

At the same time, a regulatory policy of food safety and product quality should not become a barrier to market development. This concerns both developed and developing countries, including the markets of the EU, North America, and other regions. The regulatory system should not include conflicting old (national) and new (international) standards. Taking into account the financial limits in Ukraine, it is expedient to develop a priority list of food quality control and monitoring issues and to concentrate on these when developing the food safety system.

Assistance provided to facilitate the introduction of international SPS quality standards for agricultural products and foodstuffs is essential for the economy to grow, reduce poverty rates, and create favorable terms for additional investments and productive collaboration between the state and private businesses.

In the areas of SPS control, quality control, and introducing relevant international standards, Ukraine has yet to pass a number legal and operational measures. For example, in the area of new seed variety certification, liberalization is needed to lower costs of introducing new varieties. Also, the time required for testing has to be shortened. In the area of quality control of milk and milk products, indices of raw milk quality have to be introduced. Ukraine, as a member of the FAO, must strengthen its connections and information exchange with the International Dairy Federation and the Codex Alimentarius Commission. The state and private milk industry enterprises must extend their membership and increase their participation in these organizations.

To harmonize national legislation with the WTO agreements related to SPS measures, it is necessary to complement current law with regulations requiring that national standards, instructions and recommendations are based in the recommenda-

tions of the Codex Alimentarius Commission, the FAO's Secretariat of the International Plant Protection Convention and the related framework of regional organizations, and the International Animal Health Organization for animal healthcare and prevention of zoonosis. This will affect several Ukrainian laws.

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THIS USAID-FUNDED STUDY challenges policymakers and stakeholders in Ukraine to design a road map to a dynamic and competitive agriculture and rural economy. We hope to challenge all participants in the policy dialogue to think carefully about how alternative actions will slow or accelerate progress toward realizing the great potential that exists in Ukraine's rural space. We urge policymakers to reject the failed policies of the past and act boldly in forging a new path for the road ahead.



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